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BY J. LAURENCE LAUGHLIN

BANKING PROGRESS

MONEY AND PRICES

CREDIT OF THE NATIONS

LATTER-DAY PROBLEMS

INDUSTRIAL AMERICA

THE PRINCIPLES OF MONEY

CHARLES SCRIBNER'S SONS

BANKING PROGRESS

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BY

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PREFACE

The story of growth, a progress from a lower to a higher plane, is always of absorbing interest in any field. In the evolution of our thinking on banking we have the complement to the history of our monetary development out of the greenback and silver stages. Although the two phases of progress are more or less related, the main significance of our banking progress is to be found in the gradual understanding of the workings of credit, and the emphasis which has inevitably been placed on the organization and flexibility of credit as a part of our industrial growth. Even though the meaning of separate events was not clear at the time of their occurrence, a glance backward from our present position shows very distinctly the country through which the road has been winding.

Having been myself in close touch with the movements which from time to time marched with our monetary and banking progress, it has been inevitable that my presentation should have the marks of the period in which the questions at issue were fought out. Indeed much of the material in this volume came forth as a part of the effort to aid in directing public opinion to an intelligent solution of difficult questions. Perhaps, for this reason, if for no other, they should have some historical value. But, in college courses on banking it may be worth while to have in compact form the sequence of

events which led finally to the possibility of the Federal Reserve Act.

Inasmuch as active charge of the educative campaign leading up to the enactment of the Federal Reserve system was laid upon me, I have been repeatedly urged to set down the inside history of the movement. It is too soon, however, to publish any such account. But it has seemed justifiable to give to the public the exact bill with its commentary (Chapter IX) which was in 1912–1913 offered by me to the framers of the bill. That it was misrepresented at the time goes without saying. Its perusal will show that its recommendations regarding the note-issues were not followed. One reason, to my mind, why its appearance now may be timely is the acute condition to-day of the note-issues and reserves, resulting from our war financing, which suggests that important changes may be ahead of us in order better to protect our note-issues from undue expansion, and better to separate our issue from our discount and deposit functions of banking. It seems strange that in the most important banking enactment of our history we should have gone back in effect to the practice of the old United States Bank wherein one cash reserve was kept for both demand-liabilities, notes and deposits. The account of the working of the Federal Reserve Act for the five years since its enactment (Chapter XI) shows some shortcomings both in policy and structure which demand attention, especially in view of the responsible position that we have assumed in the world of credit.

J. Laurence Laughlin.

Boston, March, 1920.

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BANKING PROGRESS

CHAPTER I

THE STANDARD QUESTION

§ 1. The concentration of public attention on burning monetary and banking questions of the day as they arose, as they were fought over and met more or less by legislation, may have prevented the most of us from seeing what has been the actual drift of monetary and banking thinking over the important period of the last twenty-five years. We may not have been able to see the forest for the trees. Yet these years have witnessed the most far-reaching changes in our understanding, as a country, of money and credit. The progressive steps in our development from questions of the standard to those of the elasticity of the currency and finally to those of the elasticity of credit are full of instruction. They record the evolution of our monetary and banking thinking. This evolutionary study, moreover, brings out the interrelation of money with banking and of banking with money both in theory and in practice. As we look back upon them these events drop into a logical sequence; but at the time each step was taken we were then very much in the dark. In fact, we were forced into progress not so much by conscious wisdom as by the stern lessons of hard experience in two panics.

The panic of 1893, due to a fear of falling to a silver standard, caused an upheaval of all our credit and banking operations. In that year we broke with our silver folly and ceased further purchases of silver by law. Then succeeded such a stirring of public interest in money and banking that we may well date our present fortunate

situation to the progress then set in motion. It came to be understood that a bad currency and banking system in itself could produce a ruinous upheaval of business. The business interests of the country, realizing that in the past monetary matters—as with the greenback and silver manias—had been neglectfully relegated to our politicians, at last became aroused and set to work to effect some essential reforms. To lay a foundation for succeeding changes the standard question was vigorously discussed. That was elemental for a further treatment of currency and credit. The cessation of silver purchases in 1893 had to be followed up by positive action to fix the standard. Then came the so-called Gold Standard Act of 1900. How far it has safely secured to us the gold standard is of first importance.

§ 2. At the time of the passage of this legislation it was repeated by the public press, and assumed by the country, chiefly on the basis of reports emanating from Washington, that the act of March 14, 1900, whatever may have been its shortcomings in other directions, had at least firmly established the gold standard in the United States. The belief was generally prevalent that the election of a President pledged to the cause of free silver could no longer be a source of danger to our monetary system, because the gold standard had been placed by the new legislation beyond the reach of executive control; that the mere action of a future secretary of the treasury hostile to gold could not cause public or private obligations to be paid in silver; and that nothing could now be done for silver except by new and positive legislation, a contingency which would be impossible so long as the Senate and the Executive favored gold. Hence we were assured that we could rest free from all danger of the

"silver issue," which we heard on all sides was "dead." On the strength of this belief, political lines were drawn, and a plan of campaign was formed. That there had been a subtle game of politics played with our monetary legislation through the influence of the Senate was unmistakably clear but was nothing unusual or surprising. It is not certain, however, that the general public was aware of the exact effect of the provisions of the new law, or informed how little had been done. Indeed, it may be a surprise to many to be told that, as regards the establishment of the gold standard, not only had practically nothing new been introduced into the situation by this law, but that we have in general no new means of maintaining the standard which we did not have before the act was passed. If there had been possible danger from silver before March 14, 1900, the same danger still exists, except so far as we have been protected by the act of December 23, 1913.[1]

In speaking of the gold standard as firmly established, one means the obligation to pay gold whenever the word "dollars" is used. As every one knows, the word "coin" allowed an uncertainty as to whether a contract generally payable in "dollars" could be paid in silver dollars (of 371¼ grains pure silver) or in gold dollars (of 23.22 grains pure gold). This uncertainty in regard to United States bonds in previous years seriously affected their value, and was one strong reason why new legislation was thought to be necessary to remove all doubt. It may, therefore, be a shock to some trusting people to be told that, in spite of the new law, a silver-loving secretary of the treasury could yet pay off large amounts of government obligations with silver dollars. If a free-silver President had entered the White House in 1901,

[1] *Cf.* Chapter X, § 4.

there would have been a large amount of obligations which could then have been paid in silver.

§ 3. Even if the standard of payments and prices may now in practice be gold, as regards both government and private debts, it is important to know how permanent this situation is. For simplicity, the matter of government bonds will be discussed first. How did the act of March 14, 1900, affect the "coin" provision in which national obligations are payable?

The contention which arose soon after the Civil War, that the debt of the United States was payable in paper, was settled in fact by the actual refunding of the whole debt under the act of July 14, 1870, which provided that the bonds issued under this law should be "redeemable in coin of the present standard value." Obviously this phrase referred to the standard coin existing before the act of 1873, and which then included silver dollars (of 371¼ grains pure silver) as well as gold dollars. Of course, silver dollars were worth more than gold dollars in 1870; and, as we all know, both gold and silver coins had been driven from circulation by the depreciated United States notes; but such facts are not to the point. Coin, in our law in 1870, included the silver dollar, whether it was in circulation or not. Hence all the bonds refunded under the act of 1870 were payable at the discretion of the Treasury either in silver or gold dollars.

The act of February 12, 1873 ("the crime of 1873"), did not abolish the legal tender value of any of the few silver dollars which might then have been in existence. It simply omitted to provide for the future coinage of silver dollars (sec. 15 and 17); and added (sec. 14):

> That the gold coins of the United States shall be a one-dollar piece, which at the standard weight of twenty-five and eight-tenths grains, shall be the unit of value, etc.

It will be seen, then, no matter what other considerations may be adduced, that under the law in 1870 "coin" certainly included silver dollars; and that the act of 1873 did not change this situation. And in declaring the gold dollar to be "the unit of value" it did not forbid the use of silver dollars in any payments public or private. The limitation on the legal tender power of silver coins in 1874 was the only change introduced at that time.[1]

The subsequent fact of importance was that all bonds of later issue (until the Spanish War Loan of 1898) had been based upon the provisions of the act of July 14, 1870. That is, the 4 per cents of 1907 were issued under that act. Also, any bonds put out under the terms of the Resumption Act of January 14, 1875, in order to obtain gold, were "of the same description as those issued by the act of July 14, 1870." Thus the extended 2s (of the loan of 1891), 5 per cents of 1904, and the 4 per cents of 1925, are covered by this latter statement. The United States bonds thus stood at the time of the passage of the act of March 14, 1900, all payable in "coin":

4 per cent bonds, 1907	$559,652,300
5 " " " 1904	100,000,000
2 " " " 1891 (extended)	25,364,500
4 " " " 1925	162,315,400
3 " " " 1898	198,678,720
	$1,046,010,920

The act of March 14, 1900, authorized a partial refunding of the old debt into 2 per cent bonds, whose principal and interest was made specifically payable in

[1] The revised statutes of June 22, 1874, inserted a provision (sec. 3586) which limited the legal tender power of all our silver coins to sums not exceeding $5.

"gold coin of the present standard value." It did not allow the refunding into the new 2s of the extended 2s of 1891, nor the 4 per cents of 1925—in all a sum of $187,679,900. In May, 1900, however, the extended 2s were called in for redemption, so that the bonds of 1925 were the only ones in fact excluded. About the close of the European War (June 30, 1918) there still remained outstanding $118,489,900 of these 4 per cents of 1925. Therefore, prevented only by the fact that they did not mature until 1925, a secretary, opposed to the gold standard, might, on a change of parties, have paid off on their maturity, in silver, since 1900, an amount of these 4 per cents varying from $118,489,900 to $162,-315,400.

The possible dangers in the act, so far as our national bonds are concerned, have been practically removed by the subsequent working of refunding measures. But no thanks are due to the framers of this law. In effect, the uncertainty of the few years after 1900 has disappeared because practically all of the old debt has been refunded in later years into the 2 per cent consols of 1930 which are specifically payable in gold.

With the above situation it must be kept in mind that the act of March 14, 1900, specifically enacted (sec. 3):

> That nothing contained in this act shall be construed to affect the legal tender quality, as now provided by law, of the silver dollar, or of any other money coined or issued by the United States.

That is, the act of February 28, 1878, which made the silver dollars "a legal tender, at their nominal value, for all debts, public and private, except where otherwise expressly stipulated in the contract," is still in operation. The outcome is a visible attempt to sit on two stools:

in one word to declare that the gold dollar shall be the standard unit of value, and in another to declare that the silver dollar shall remain an unlimited legal tender. The political legerdemain in this action depends upon the inability of the public to separate the assignment of legal tender quality to the standard (in which prices and contracts are expressed) from the assignment of it to a token money (which should be redeemable in the standard money). Because the standard money is made legal tender, it does not follow that a medium of exchange (such, for example, as national bank notes, or checks and drafts) should have that quality.

The dodging of the standard issue in regard to government obligations cannot be excused on the ground of inadvertence. The House bill (sec. 2) read:

> That all interest-bearing obligations of the United States for the payment of money, now existing or hereafter to be entered into, . . . shall be deemed and held to be payable in the gold coin of the United States as defined in section 1 of this act.

These words did not appear in the Senate bill, and were excluded from the conference bill. In short, for political reasons, the Senate leaders advisedly chose to modify the currency measure in such a way that it could still be said that a large part of our national obligations were payable in silver; while scheming for votes in the East on the ground of having established the gold standard, it would be possible to ask for votes in the Rocky Mountain States on the ground of having preserved the right to pay a large part of the bonds in silver. It must be said, therefore, that the new act established the payment in gold of only a part of our government obligations in existence at that time (and also that this amount

depended upon how far they were later refunded into the new 2s).

§ 4. The consideration, however, of most importance to the business public is the certainty of the standard in ordinary private contracts drawn in "dollars," without a specific agreement to pay gold. Obviously, it may be said that the national bonds could not be paid in silver in any event until the time of maturity, and that such a fear need not give much cause for distrust. But as to private debts, falling due from day to day, every one realizes it to be a matter of present concern. Since the unlimited legal tender power of the silver dollar is retained for all obligations in which gold is not expressly stipulated, it is clear that all private contracts thus generally drawn could be liquidated in silver. The gold standard of payments, therefore, is not made obligatory for private debts. The new law manifestly did not establish the gold standard for the ordinary transactions of daily business life. If a lender of money wishes to secure repayment in gold, he must, to-day, as well as before this act was passed, expressly stipulate for gold in the contract. The act of March 14, 1900, did not give us any new protection in this regard. Hence we ought to give up the fiction that the new law "established the gold standard."

§ 5. Since silver dollars can be paid for public and private debts in nearly as many cases now as before the act of 1900, the question then arises as to whether the permanence of the gold standard had been assured by any provisions for maintaining silver at par with gold. Certainly, a reader might say, so long as silver is kept in value equal to gold, no one would object to being paid

in silver; and reference might be made to the fact that the act (sec. 1) not only declared the gold dollar to be "the standard unit of value," but also that "all forms of money issued or coined by the United States shall be maintained at a parity of value with this standard, and it shall be the duty of the Secretary of the Treasury to maintain such parity." To the innocent reader this may look like a veritable establishment of the parity of silver with gold. But it adds nothing that did not exist in the law before (in the acts of July 14, 1890, and November 1, 1893).[1] It pretends to establish parity by command, but it gives absolutely nothing with which to maintain parity. Suppose that Congress had ordained that the navy should have had all the old powder exchanged for smokeless powder, and that it should have made it the duty of the secrctary of the navy to make such exchange, and had provided no appropriation for this purpose, nor allowed any new machinery for carrying out the plan beyond what existed before. Should we not regard this as something more than trickery? Certainly: it would be an insult to the intelligence of the public. In that monetary law, we had actually no means

[1] Act of July 14, 1890 (sec. 2): "That upon demand of the holder of any of the Treasury notes herein provided for the Secretary of the Treasury shall, under such regulations as he may prescribe, redeem such notes in gold or silver coin, at his discretion, it being the established policy of the United States to maintain the two metals on a parity with each other upon the present ratio, or such ratio as may be provided by law."

Act of November 1, 1893: "And it is hereby declared to be the policy of the United States to continue the use of both gold and silver as standard money, and to coin both gold and silver into money of equal intrinsic and exchangeable value, such equality to be secured through international agreement, or by such safeguards of legislation as will insure the maintenance of the parity in value of the coins of the two metals, and the equal power of every dollar at all times in the markets and in the payment of debts. And it is hereby further declared that the efforts of the Government should be steadily directed to the establishment of such a safe system of bimetallism as will maintain at all times the equal power of every dollar coined or issued by the United States, in the markets and in the payment of debts."

of maintaining silver dollars at par with gold which did not exist before the act was passed. Here again, the jugglery of the Senate leaders showed itself. The House bill ran (sec. 4):

> The Secretary of the Treasury is authorized and required to use said [gold] reserve in maintaining at all times the parity and equal value of *every dollar issued or coined* by the government; and if at any time the Secretary of the Treasury deems it necessary in order to maintain the parity and equal value of *all the money* of the United States, he may at his discretion exchange gold coin for any other money issued or coined by the United States.

In short, the House bill set out to provide a gold reserve to be used for the maintenance of the parity of all kinds of our money; but the Senate overruled this plan, and limited the use of the gold reserve solely to United States notes and treasury notes of 1890. That is, if the Treasury should find difficulty in keeping about 579,000,000 of silver dollars at par with gold, he could not use the new gold reserve (for the replenishment of which provision was made by selling bonds). All the regulations of the reserve applied to the two forms of paper (amounting to about $426,000,000), while about 575,000,000 dollars of silver, which carried a seignorage of over 50 per cent, were left without any direct means of redemption into gold, as a means of keeping the parity. I have said that the permanence of the gold standard depends upon the provisions of that law as to maintaining the parity between gold and silver; but we now see that no new means whatever had been given to accomplish this end. Such methods of keeping silver at a parity with gold which existed before the act of March 14, 1900, are still the only means we now have of assuring the continuance of the gold standard. That law had not

given us any new methods of redemption.[1] Here we had an exhibition of gross cowardice on the part of Congress. Although no other enactments have been later made for gold reserves against United States notes or silver currency, yet so long as Federal Reserve notes remain redeemable in gold as required by the act of December 23, 1913, all other forms of money which are in practice used interchangeably with Reserve notes will have the same value.

In one respect, however, that legislation bettered the chances of keeping our silver at par with gold. By the withdrawal of United States notes and national bank notes (except one-third of the new circulation) in denominations below $10, and by reducing the large silver certificates to small denominations to take their place, an additional use was created for the silver money, and therefore there will be less reason for its redundancy and consequently for its presentation at the Treasury in payment of customs in a process of indirect redemption. By increasing the probability of keeping silver permanently in circulation for purposes of change it became less dangerous.

But this gain was fully offset by the provisions of the act which affected the silver bullion behind the treasury notes of 1890, and which increased the quantity of silver dollars to be kept at a parity. Here we have another sop to Cerberus. From a sane point of view it is not much more creditable than the measure to coin the seignorage which was defeated some years before. Under the act of July 14, 1890, 168,674,682.53 ounces of

[1] How silver has been, in fact, kept at par with gold in the past by an indirect system of redemption through the payment of customs, and by the complementary offer of gold to all creditors of the Treasury, I need not go into here. *Cf.* my *History of Bimetallism in the United States*, 4th ed., pp. 253–255. *Cf.* Chapter X, § 4, for effect of the Federal Reserve Act.

fine silver were bought by the issue of $155,931,002.25 of treasury notes. The average price paid per ounce for this bullion was $0.9244;[1] and as the price soon fell about one-third, the value behind the notes became one-third less. But if this bullion were coined into silver dollars (at the rate of 371¼ grains each), the 168,674,682.53 fine ounces would yield about 218,000,000 silver dollars. Then, instead of $155,931,002.25 treasury notes to look after, there would have been a vastly larger bulk of silver dollars to be added to those previously coined under the act of 1878. The disposition of this bullion is a fair test of the animus of the new legislation. One bit of help existed in the permission to use enough of the bullion to increase the subsidiary coinage to 100,000,000 dollars; and since the amount outstanding March 1, 1900, was $80,101,151, it appears that an increase of nominal face value to the sum of about 20,000,000 dollars (or about 14,000,000 fine ounces) was possible. With this exception the act emphasized the policy of coining the rest of the bullion into dollar pieces and retiring the treasury notes. It is doubtless generally understood how the terms of the act of July 14, 1890, has in fact brought about a gradual extinction of treasury notes of 1890. This process was established in the words (sec. 2):

> *No greater or less* amount of such notes shall be outstanding at any time than the cost of the silver bullion and the standard silver dollars coined therefrom, then held in the treasury purchased by such notes.

Hence treasury notes, when redeemed by gold, would be reissued in order to keep the amount equal to the

[1] The rise in the price of silver bullion to over $1.30 in 1919 would make it possible for the Treasury to reduce its holdings at a profit. But this rise could not possibly have been foreseen.

silver bullion plus the silver dollars held; but when redeemed by silver, the treasury notes would be cancelled in order to keep the amount outstanding no greater nor less than the silver bullion plus the diminished number of silver dollars held. The released silver dollars, if returned in any way to the Treasury, could then become the basis of additional silver certificates (but never of treasury notes). This explains why the treasury notes were gradually being reduced in volume, coincident with an increase of silver dollars and silver certificates.

The act of June 13, 1898 (the Spanish War Loan and Revenue Act), stimulated this process by the following requirement (sec. 34):

> That the Secretary of the Treasury is hereby authorized and directed to coin into standard silver dollars as rapidly as the public interests may require, to an amount, however, of not less than one and one-half millions of dollars in each month, all of the silver bullion now in the Treasury purchased in accordance with the provisions of the act approved July 14, 1890, . . . and said dollars, when so coined, shall be used and applied in the manner and for the purposes named in said act.

Then the act of March 14, 1900, specified that as fast as silver dollars were coined under the foregoing laws, the secretary should (sec. 5):

> retire and cancel an equal amount of Treasury notes whenever received into the Treasury, either by exchange in accordance with the provisions of this act or in the ordinary course of business, and upon the cancellation of Treasury notes silver certificates shall be issued against the silver dollars so coined.

In this way that law brought about the cancellation of treasury notes without waiting for the former process of redemption by silver, thus hastening the conversion of treasury notes into silver certificates. The only ad-

vantage to be gained from this action was the final disappearance of one of the too many kinds of money which make up our circulation.

When that law came into force there were only $86,-776,000 treasury notes outstanding, supported by bullion costing $77,402,692, plus 9,373,308 silver dollars. The number of ounces of fine silver uncoined at that date was about 85,550,000. Consequently, instead of $155,000,000 in treasury notes, there would be about 200,000,000 in silver dollars when conversion had been completed, or an increase of not less than 45,000,000 dollars. This increased volume of silver dollars would raise the total issue (including the 378,000,000 dollars coined under the act of 1878) to about 578,000,000 dollars. For the maintenance of this vast sum at a parity with gold, when each silver dollar was then actually worth only about 47 cents, there was absolutely no method of direct redemption in gold. And the act of March 14, 1900, gave no new provisions whatever to accomplish this end, or to support its windy and virtuous order to the secretary to maintain the parity. So far as any new power was given him to carry out the purpose, Congress might as well have ordered the secretary to see that every citizen of the United States should have blue eyes.

§ 6. It will be noticed that all the machinery for a gold reserve, its increase to $150,000,000, its replenishment from sales of bonds, etc., had to do solely with protection to the United States notes and treasury notes of 1890. Hence, when the latter have ceased to exist, the gold reserve will remain only for the government paper, with nothing in reserve for our token silver. The ominous feature of this arrangement is the evident intention

to regard the United States notes as a permanent part of the circulation. No suggestion whatever is made as to the future retirement of any portion of this form of our money. That, it is clear, must be reserved for future reforms.

But although the act of 1900 gave us no firmer hold on the gold standard, and did nothing to remove the United States notes, it has, indeed, secured to us a reform which, in possibilities of safety in the future, wholly outweighs any other feature of the act. No one who has watched carefully the origins of our paper-money delusions will fail to realize how dangerous was the confusion in the minds of our legislators in the past between the monetary and the fiscal functions of the Treasury. It was this confusion which, in 1862, led to borrowing in the form of demand obligations to be used as money; to a depreciation of the standard of prices; to the destruction of our credit in the loan market; to the appearance of speculation and unsettled business conditions—and all the evils of a fluctuating currency. Since the resumption of specie payments in 1879, the gold reserve had been a part of the general fund applicable to fiscal purposes in cases of deficit as well as to the redemption of our paper money. For this reason we got into serious trouble when deficits used up the gold reserves, because fiscal operations took immediate effect on the reserves protecting the character of our standard of prices and contracts. No mere question of revenue and expenditure of the general treasury should ever be permitted to have such an influence on our standard that business could be thereby seriously crippled. It is such an anomalous situation as this which we are happy to say has been made impossible by the distinct separation of the funds used for reserves behind the government paper

from other cash in the hands of the State. This appeared in the new form of treasury statements. In the years to come nothing we have accomplished ought to have done more than this one provision to clarify the public mind as to the true status of our paper money, and to save us from stupid blundering. While this part of the act excited little comment in the press, it was of first importance as a piece of positive legislation. This one measure would alone have made the act prominent in the history of monetary legislation since the Civil War. But we again relapsed into much the same difficulty with the Federal Reserve Act during the war (see Chapter XI).

The regulations by which the gold reserve for government paper is to be maintained, and the details of redemption, are doubtless clumsy, and drawn in such a way as to escape political attack; but there is little reason to believe that they will not work out successfully in practice. Certainly the redeemability of the United States notes and the treasury notes of 1890 was provided for beyond peradventure in the permission to sell bonds to protect the gold reserve. But the separation of the issue and redemption departments from the general treasury funds makes entirely clear that no gold in the former can ever be used in the indirect or direct redemption of silver dollars; and that the character of the silver circulation will depend wholly upon the composition of the free treasury balance. If gold should not readily come in for revenue, or if redundant silver or other currency should be paid in instead, the free balance would more quickly than of old indicate the difficulty of maintaining our large silver circulation at a parity with gold.

§ 7. This act, however, was not concerned only with the standard. It also touched on the subject of banking.

The sections of the law relating to banking, however, may be dismissed in a few words, because the changes proposed were unimportant. The reduction in the tax on circulation, and the increase in the amount of notes issued by banks to 100 per cent of the value of the bonds, had some influence in expanding the circulation.

The refunding provisions, however, were of an important character. They were important because, in order to serve a political end, one of the generally accepted principles of finance was violated. There can be no doubt that the extension of the term of the new bonds to thirty years had only political considerations behind it. It is almost inconceivable in a modern community that a State should put its bonds in a form where they cannot be paid off within a reasonable period. After the extended 2s were paid off (a process then going on), and after all the old bonds were refunded into the new loan, our national debt could not be reduced (except by purchase in the open market) before the 4s of 1925 matured. So flagrant an abuse of sound finance could be explained only on the supposition that a supply of national bonds would be assured for a generation to come in quantity sufficient for the security of the national bank circulation. Such was the adroit move by which the Senate leaders supposedly succeeded in shelving for decades the demand for an elastic bank currency based upon commercial assets. And if the refunding measure released a considerable sum from the Treasury in payment of premiums, and caused an enlargement of the banking circulation, it would be supposed to ease the money market during a presidential year, aid in the "prosperity" argument, and assist in the political purposes of the party in power. In general, it can be said that the new measure did not add anything of value to the machinery by which the

banks were enabled to adjust the supply of currency automatically to the needs of the public. Many small banks, and some large ones, would no doubt be established, or come into the system, but after that increase, the rigidity of the old system would remain with all its well-known characteristics.

CHAPTER II

ELASTICITY OF BANK-ISSUES

§ 1. In the United States after the long struggle for a stable standard of prices—ranging over the greenback and silver campaigns from 1874 to 1896—the attention of intelligent reformers seemed to have centred on obtaining an elastic currency. Elasticity meant, of course, the power to contract as well as to expand according to the needs of trade and credit. Although the tremendous losses from the panic of 1893, due to the fear of a silver standard, directly led to the legislation on the standard in 1900, there was running through all minds in the same years, mingling with the discussion on the standard, an accompaniment of deep discontent regarding the condition of our paper circulation, its safety, and especially its flexibility. It was not then perceived that the pivotal matter, underneath all questions of paper money and its elasticity, was a flexible working of credit. It was then believed that our paper currency, whether issued by the government or by the banks, if properly conditioned, would provide all the elasticity needed by a good currency system. Indeed, the power to issue notes was regarded by most public men as the central point of currency philosophy. If the government should retain the control over paper issues, according to some persons, credit and prices would be under control. Or, if banks were to be allowed to issue notes, all legislation should lay emphasis on these notes, their quantity, their relation to the bank's capital, and their safety; yet all the while, the banks, through their credit operations, carried out by

checks drawn on deposits, were exercising a currency function far and away more extensive and important than any performed by paper money. In the evolution of our thinking on money and credit an understanding of these latter operations did not early come to the front. Meantime, our minds were mainly occupied—as they had been in fact since early in the previous century—with questions as to the issue of notes. Fundamental to the settlement of these problems was a weighing of the relative value of a system of governmental issues in contrast with that of bank-issues.[1] That we should, because of inherited prejudices and the accidental legislation of the Civil War, in spite of opposing experience in Great Britain and on the Continent, have clung to the issue of governmental paper (although limited in amount) even to the present day, and after the passage of the Federal Reserve Act, is a curious case of persistency in a dangerous expedient.

Nevertheless, even though the greenback has by tacit acquiescence remained as a rigid part of our currency, there has arisen without debate and almost unconsciously a wide-spread sentiment in favor of bank-issues. This opinion grew no doubt because of a belief that the well-recognized inelasticity of the national bank notes could be removed.

§ 2. It is well here briefly to recall the reasons why the old national bank notes, before the enactment of the Federal Reserve Act, were signally inelastic; for they are typical of any system of issues secured by bonds.

First, these notes were inelastic because they could not be readily expanded to meet the needs of any sudden demand. The method of their issue is well known:

[1] *Cf.* Laughlin, *Money and Prices* (1919), chap. X.

The national banks could take out new circulation only by securing and depositing United States bonds with the comptroller of the currency. Since these notes were printed from separate plates for each bank, the sending in of bonds, the printing of the notes in Washington, their shipment to the bank, and the signing of the notes by the respective bank officials, caused more or less delay before the notes were ready to be issued. At least three weeks were thus consumed. This delay was such that, unless foreseen, bank-notes could seldom be obtained quickly enough to meet a sudden demand for cash.

Moreover, the motive for issuing notes based on bonds is not the needs of business, but the possibility of profit to the bank. The prospect of profit, however, is complicated with many considerations outside the control of the bank. The price which must be paid for bonds necessarily affects the willingness of the banks to issue notes; and yet in past years the quantity and kind of government bonds available, and consequently their price, have varied greatly. The prices of bonds may fluctuate either because of changes in the credit of the government, or changes in the current rate of interest. If our credit improves, bonds paying more than a normal rate rise in value; or, other things remaining the same, a fall in the market rate of interest will cause a rise in the price of bonds having a fixed return. Moreover, the term for which a bond runs affects its price: as a bond approaches maturity it will drop to par; if yielding more than the market rate of interest a long-term bond, not paying as much as a short-term bond, might command a high premium.

A bank makes its profit by the discount on a loan. If a borrower, however, wishes bank-notes, the profit to

the bank will be affected by the expense of issuing notes; that is, the gain from the market rate on the loan would be affected by the interest paid on the securities required to obtain the notes. A high market rate of interest tends to prevent the issue of notes secured by bonds. Instead of investing in these bonds, by lending their funds direct to borrowers who ask only a deposit-account and the right to draw on it with checks, a bank can earn larger profits.

Also, until 1900, notes to only 90 per cent of the par value of the bonds could be issued. That is, taking $100 out of the cash resources of a bank in order to obtain $90 (and later $100) in their own notes meant that giving credit to those wishing a note-liability (instead of a deposit-liability) crippled the power of a bank to earn profits. Hence in the years 1883–1893 there was a marked decline in the national bank circulation. Thereafter, from $178,713,692 in 1893, it grew to $353,742,186 in 1901, and to $759,157,906 in 1913 (the year of the Federal Reserve Act).

Changes in conditions outside the control of the banks produce an effect on their profits and on the amount of the circulation issued. Experience has shown that a system of notes secured by bonds is inconsistent with the automatic adjustment of the quantity of the circulation to the demands of the public and the needs of trade. When the demand for loans is great and the market rate of interest is high, there is little profit in issuing notes; in short, when the demand may be urgent, the supply may not be forthcoming.

On the other hand, if the country is suffering from business depression, if funds are accumulating in the banks, and if the market rate of interest is low because there are few opportunities of profitably employing capital, then it would be natural to expect the banks to use

superabundant funds in buying safe bonds of a low rate of interest. Therefore, at a time when the demand for loans is slight and the rate of discount is low, it would be easy for the banks to invest in bonds and thereby obtain notes. In short, when there is no demand, the supply is easily obtained. It needs no further comment, consequently, to see that such a system of note-issues works at cross purposes with the needs of the public. With a deposit of bonds for security of notes, there is likely to be no supply of notes at a time when most needed and an abundant supply when least needed.[1]

Moreover, a bond-secured circulation is limited by the supply of available bonds having the circulation privilege (*i. e.*, the right to be deposited to secure notes). The maximum of such notes is thus restricted, not by the needs of business, but by the total supply of bonds. In the years before the European War, when our national debt was being reduced, this supply of bonds was so limited that the 2 per cent bonds possessing the circulation privilege were thereby given a value far above their investment price. Also, the practice of the Treasury in requiring bonds to be deposited by banks to the amount of government funds received created an additional demand for bonds. Thus at the very time when there was a large Treasury surplus there was a tendency to limit the bonds available for note-issues; and yet this was a time of general prosperity when a demand on the banks for loans, and incidentally for currency, would be strong. Of course, since the large issue of government bonds during the European War, there could be no lack of bonds for this purpose, if it were a desirable one in itself.

[1] See *Report of the Monetary Commission* of 1898, p. 228, and also secs. 133–136, 103–110. Also see *Banking Reform*, National Citizens League (1912), chaps. IV and VIII.

In the second place, national bank notes were inelastic because their contraction was even more delayed than their expansion. Elasticity, as already said, implies two conditions: (1) immediate expansion whenever there is an increased demand for currency; and (2) prompt retirement as soon as the need for it has passed. The proper supply needed by the public is always automatically adjusted to the need, if there is a system of easy and immediate redemption. In short, immediate redemption necessarily secures not only the parity of the notes but the impossibility of a superabundant circulation.

The redemption of national bank notes was imperfect. The very uniformity and safety of these notes constituted the reason why they would not be sent in for redemption by any one else than the issuing bank. Its circulation being out in all parts of the country, a bank could seldom get hold of its own notes. Only as they happened to be sent in to the one redemption agency in Washington could a bank secure a return of its own notes. To withdraw its circulation, a bank could deposit lawful money with the Treasury to the amount of the notes to be retired, and thereupon take away the bonds kept for their ultimate redemption. This "doomed circulation" remained out in the hands of the public until they were either sent in by other banks or became so mutilated that they would appear at the redemption agency to be exchanged for fresh notes. Therefore, not only was the withdrawal of notes unreasonably delayed, but the contraction was accomplished only by the hiding away in the Treasury of an equivalent sum of lawful money. Moreover, by the act of July 22, 1882, no more than $3,000,000 could be withdrawn in any one month; on March 4, 1907, this amount was fixed at $9,000,000.

Consequently, when, in times of an urgent demand for notes, a bank was induced to issue notes temporarily, it knew that it would be practically impossible to withdraw them until long after the emergency had passed. Sometimes a bank found it had outstanding all the notes it could care for, and when asked for notes by its customers could get them only by borrowing them from banks (usually large city banks) which had not fully used their privilege of issue.

So far as the actual use of money is concerned, when passed from hand to hand, there are seasonal variations in the demand, arising from methods of doing business, and especially from the ebb and flow of industrial activity at different seasons. Thus there are varying demands for a medium of exchange for pay-rolls, payment of dividends on stocks and bonds at quarterly or semiannual periods, or the marketing of the crops in the autumn. For such purposes the characteristic of expanding and contracting with seasonal needs was regarded as very important. Of course, the national bank notes lacked such elasticity. For many years, while the attention of currency reformers was concentrated on elasticity of the currency, the Canadian and Scotch banking system was highly praised by contrast with our own in this respect. It was found that the life of a national bank note, due to the extreme slowness of redemption, was about two years, while that of a Canadian bank note was only thirty days, and of a Scotch note eighteen days.[1]

The sum of the whole matter is that under the existing system of bank-notes based upon government bonds, normal and authentic expansion and contraction of the currency, in response to needs of trade, is flatly impossible. The currency

[1] See *Report of Monetary Commission* of 1898, secs. 207–225.

supply may be greatly enlarged in the dull midsummer months and suddenly contracted when the active autumn business season begins. It may increase rapidly at a time when trade reaction has reduced to a minimum the necessities for even the existing bank-note supply, or it may be as rapidly reduced when large harvests, full employment of labor, and active hand-to-hand use of currency most need a larger circulating medium. That there is no remedy for this abnormal situation, except the substitution of some other system for that which prescribes the United States Government bond as a basis for bank-note issues, every economist at all familiar with the question agrees.[1]

§ 3. This matter of the inelasticity of our currency was probably overemphasized. It was not realized that it was only one phase of a larger question. It was, of course, true that a certain marginal elasticity on the general amount of our circulation was quite important. Nevertheless, it is now clearly seen that a few years ago, under a demand for an elastic currency, it was supposed that issues of notes would be a remedy for the disasters of a financial panic. Such a point of view ignored the deeper and wider question of credit and the lending power of the banks. In a time of panic what a hard-pressed business man wanted was a loan, and, if this was granted, he found a perfectly elastic medium of exchange at all times in the deposit-currency (*i. e.*, checks drawn on deposit-accounts). The resort to the issue of clearing-house certificates in times of stress was not made to furnish a medium of exchange, but to make loans possible. The matter of elastic bank-notes, although necessary, was certain to be overshadowed sooner or later by the demand for a better organization of credit. One of the important objections to the old national banking system

[1] A. D. Noyes, *History of the National Bank Currency*, p. 20 (issued by National Monetary Commission).

was that the bond requirement really limited the lending power of a national bank. To see these things, however, there was needed a long education and a slow evolution in our thinking about banks. Banking progress did not come at once. The greater need of the elasticity of credit, which was later brought about by the Federal Reserve Act of 1913, was not then understood.

It was the experience with the national bank notes (all other forms of our paper being rigidly inelastic) that forced attention on remedial measures aiming at elasticity in general. Then began the agitation against a bond-secured system of note-issues and for some method of safely securing the notes by commercial assets which has since gone on to its final consummation in the Federal Reserve Act. The fear of undue expansion and of lack of security behind such notes produced no little timidity in venturing on new experiments. This point of view accounts for the constant endeavor in all schemes to relate the amount of issues to a percentage of the capital of the issuing bank; yet the issues are in truth functionally related not to the capital but to the assets of the bank.

It is interesting to record that the first definite proposal to use commercial assets came from the American Bankers' Association in 1894, and was known as the "Baltimore Plan." Although it did not come to fruition, it was important in blazing the way for later possibilities.

In brief, it was proposed to allow the national banks under federal supervision to issue circulating notes secured by (1) a first lien upon the assets of the issuing bank, (2) the double liability of shareholders, (3) the 5 per cent redemption fund, and (4) a 5 per cent guaranty fund. In case of failed banks the guaranty fund could be replenished, if necessary, by use of the prior lien. It

will be observed that the noteholder was given a prior claim over the depositor, thus retaining the intent of the former method of segregating assets in the form of bonds to protect the notes. In addition, the amount of notes was restricted and taxed to insure their retirement when the need for their issue had disappeared. To 50 per cent of the paid-up, unimpaired capital of the bank the tax on the notes was $\frac{1}{2}$ of 1 per cent; and additional issues were allowed up to 75 per cent of the capital, but subject to a much heavier tax. Thus the maximum issue permitted was 75 per cent of the capital. This was a serious check on elasticity.

§ 4. How this proposal was received at the time and the attitude toward it belongs to our monetary history. The Baltimore Plan, thus presented, dealt solely with the function of note-issues of banks, totally disregarding the two other important functions, namely, deposit and discount. It did not propose to modify existing law with regard to the immediate redemption of bank-notes. The redemption fund of 5 per cent in Washington and the usual requirements for redeeming notes at their counters were to remain untouched. The plan proposed a radical and drastic change in the provisions of the existing law as to the ultimate redemption of national bank notes. At that time the ultimate redemption and security for bank-notes were United States bonds. A bank could then issue notes up to 90 per cent of the par value of the bonds. The Baltimore Plan instead proposed a 5 per cent guaranty fund held by the government, then a prior lien on all the assets of the bank, and if this were insufficient, then on the stockholders' liabilities.

The security to the note-issues was large and unquestionable. The prior lien on the assets is not really un-

derstood. As is proper, it gave the noteholder a lien before the depositor on all the assets. The limitation of the amount of issues to 50 or 75 per cent of the unimpaired paid-up capital was a mere formality, so far as security goes. There is no measure whatever of the assets of a bank in comparing them with its paid-up capital. The item of loans may be enormously larger than capital, and that is so in every strong, well-trusted bank. For example, some years ago the Chemical Bank of New York had a capital of $300,000, but loans of perhaps $15,000,000 or $20,000,000; and the relation of capital to assets was much the same in such a bank as the First National Bank of Chicago. Therefore the limitation of issues to a certain percentage of capital gives a security in assets out of all proportion merely to capital.

Secretary Carlisle modified the Baltimore Plan in favor of greater security to noteholders. He proposed, first, a deposit of 30 per cent of the circulation in legal money with the government; then, second, the safety fund of 5 per cent; third, a requirement upon all other banks to fill up deficiencies in these two funds of any failed bank; fourth, a lien upon all the assets, and, fifth, a further lien upon the stockholders' liability.

Both these plans mentioned agreed in limiting the issues to a percentage of 50 or 75 per cent of the paid-up capital. Hitherto we had been complaining of the inelastic character of our "greenbacks" as a reason for their retirement; but in the new plans it was made impossible to issue more notes than a certain percentage of bank capital. But national bank capital is not an elastic thing. Indeed, it had not changed greatly in years. In 1875 it was $504,000,000, in 1893 it had increased only to $678,000,000; while the total amount of our circulation increased from $754,000,000 in 1875 to about $1,600,000,000 in 1893; and population had in the same period

grown from 41,000,000 to 66,000,000. We see therefore that the new scheme set up an inelastic barrier of bank capital, and determined the amount of the issues by taking a certain percentage of that inelastic capital. To this extent the new schemes, while to be approved in general, were defective.

Most of the objections made against the Baltimore Plan and in the general discussion of currency at that time were based upon the insufficiency of the supply of gold, as if that had caused a fall of prices, and the need of more money. From 1850 to 1875 there had been produced as much gold as was produced from the discovery of America in 1492 to 1850—three hundred and fifty-seven years. In forty years we had produced about \$5,300,000,000 of gold as against the production before 1850 of about \$3,000,000,000. Judging from the statistics of Adolph Soetbeer, the German statistician, on the product of gold and silver, the difficulty is to discover what had become of the gold. In the last statement of the Mint preceding 1894 of the amount of gold in all the currencies of the world, even including such countries as Japan, the total amount of gold in use as money amounted to about \$3,500,000,000. We had in existence in 1850 probably not more than \$2,000,000,000 of gold.[1] We produced from 1850 to 1893, \$5,300,000,000 of gold. We have difficulty in accounting for nearly \$1,800,000,000 of gold that we cannot find in the currencies of the world. Since that time gold has gone on increasing. There is more gold to-day in the circulation of the world than there has ever been at any time in history.

§ 5. In all these plans we were really aiming to prevent the difficulties experienced in 1893, when we re-

[1] See Laughlin, *Money and Prices*, p. 86.

sorted so largely to clearing-house certificates. Let us see just what took place, and what the remedy should be. In normal times before a panic one man sells his goods expressed in terms of the standard money, drawing a bill on the buyer or getting his note, discounting the bills or notes at his bank, getting a corresponding deposit, and paying his own debts by drawing checks on the accounts thus created. And so with others; not only this man, but most men in ordinary business. Not more than 5 per cent of wholesale transactions are carried on by actual money used as a medium of exchange. Ninety-five per cent of the goods are transferred by some credit device; the media of exchange are not wholly money but mainly bills and checks. These latter media are elastic, perfectly elastic. They expand exactly in proportion to the work to be done.

Then what happens in a panic like that of 1893? Many purchasers have obligations maturing at fixed dates, and these obligations are drawn in terms of the standard. This standard is gold. Every one is liquidating—selling property, stocks, bonds, in order to get that which would meet these obligations. If they are not met, financial failure is the result. Is it actual coin or bank-notes that every one needs to get means of payment? If a bank will lend him on his assets, and credit him with a deposit, he is safe. So long as a bank is able and willing to give loans on assets, that is, translate them into means of payment, all goes well. In short, the crux of the whole matter is traceable to the banks. Can they expand loans sufficiently? Can they furnish all the means of payment needed to enable every borrower having bankable goods to avoid bankruptcy when his obligations mature? That is the real question. Is there elasticity of credit? In a panic all depends on

the answer to this. Now, how does the elasticity of note-issues affect the situation?

In the stress of a panic, what is needed is not elasticity in only one form of immediate liability. In order to enable a bank to loan, and so stop the pressure, it is not enough to have an elastic limit only to the note-issues. The same operation can be carried through by a deposit-account, and that method is unrestricted by law. Indeed, as a matter of fact, the largest banks make almost no use of their note-liability, and use only the deposit-liability. We see, therefore, that calling attention solely to the elasticity of note-issues in the Baltimore Plan does not meet the whole need. Grant that we have this elasticity of note-issues, we shall not then be able to meet the difficulties which will inevitably arise in times of stringency as certainly as the sun rises in the cast. To be sure, so far as the note-liability is used from hand to hand in retail and small transactions, it is well to have the issues of them answer promptly to the demand, provided safety is secured. Then both forms of immediate liability—first, deposit-credit, and second, note-issues—will freely respond to the demand of customers, whenever a bank can lend at all. But it must not be supposed that an elastic note-issue is a universal panacea for commercial crises.

§ 6. Here it may not be amiss to refer to an elementary matter in banking. A bank makes its profit through buying a debt due in the future by giving for it a debt due at the present time. That is, it buys a note, or discounts a bill, say, at sixty days, with collateral, and gives for it an immediate liability. But the forms in which a bank gives an immediate liability are two—which one it will use depends on the customs and preferences of its

clientèle. First, if its customers are engaged in large transactions, as in a city, they use checks almost entirely. Therefore the bank finds that making a deposit-account is the form of immediate liability which will be generally used. Second, if its customers always pay money from hand to hand, the bank finds that its borrowers ask for that form of immediate liability called a note-issue. Other things being equal, it makes no difference to the profit of a bank which is used; the choice between the two depends upon its customers.

It seems that there existed in this country a most extraordinary prejudice against banking. It must be based only on ignorance of what the banking business is. Therefore, it may be well to explain in brief what a bank is. It is not different in essence from a store which sells hardware or corn. It has its legitimate function in business, just as any shop has. It buys and sells something. It gets a profit because it buys a larger debt payable in the future with a smaller debt payable at the present moment. Its profit is there and nowhere else. It does not make its profit on the issue of notes.[1]

The mental confusion on monetary subjects is too often connected with a failure to distinguish between the production and the exchange of goods. Money is a machine by which goods are exchanged after they are produced. It is not a factor of production. Increasing the amount of money does not increase goods in other forms. By increasing the number of railways between Chicago and St. Paul, the number of bushels of corn and wheat to be carried on those railways is not increased. An increase of the means of transportation does not increase the quantity of goods to be transported. It may, indeed,

[1] For a full discussion on this point, see *Report of Monetary Commission* of 1898, secs. 103–110.

even produce the opposite effect; an excessive transfer of saved wealth into railway embankments might leave less to be devoted to the production of goods seeking transportation. The case is precisely the same with money. Money is only the machinery by which goods are exchanged against one another. No matter how valuable, it is not wanted as a medium of exchange for its own sake, but for what it will buy. We do not eat or drink the money itself. It is only a means to an end; it is like the bridge over a river—a mechanism by which we get goods from one shore to the other. To confuse money with the goods it transfers is like failing to distinguish between the bridge and the corn and pork which pass over it. To suppose that coining more silver would make the country richer is to suppose that the more bridges we build the more corn and pork we shall have; or that the more railways we build between Chicago and New York, the more goods there will be to pass to and fro. Once the real work performed by money is apprehended, the fallacy of the demand for more of it becomes clearly apparent. It is an insult to the intelligent people of our land to believe that they can accept and maintain a doctrine that more money creates more goods. As well try to persuade them that the more shoe-strings they have the more shoes they own. Stupid legislation on money has done incalculable harm. It brought us the panic of 1893. When the chicken-hawk of monetary idiocy appears in the sky, the shy chickens of capital and industry scurry to cover.

In this connection it may be well to point to one of the most important of all the recommendations in Mr. Carlisle's message. It was tucked away in the end of an innocent-looking sentence of the President's message, but was more fully developed by the secretary himself.

He advocated the abolition of fixed reserves for deposits. This, with the proposal to withdraw the greenbacks, was the most refreshing talk we had had for years. To abolish the fixed reserve might help more to aid borrowers in a panic than to make note-issues elastic. It touched the vital relations between the three items of most importance in a bank-account—the loans, the deposit-liability, and the reserves. It helped to allow the bank to discount at the most critical time. As our laws then stood (1894), they aided in the ruin of the hard-pressed borrower, although he could offer good collateral; at the very moment of greatest need they forbade the bank to loan at the risk of losing its charter. At the very time when loans were most needed and reserves were at the legal minimum, banks were forced to cease discounting. If this change should be adopted, however, there should go with it the repeal of State laws limiting the rates of discount.

Nothing in the proposals for currency reform is more commendable than the proposal to retire the United States notes. The government in its struggle to maintain our standard by selling bonds furnished a lesson which should not pass unheeded. The whole matter was undignified and unsafe. Why should the whole business of the country wait on the fluctuating politics of a Congress chosen, as a rule, not for financial experience, but for political prowess?

The government should not issue notes, for many reasons: First, because no government can determine the amount of issues which would satisfy business, and which should be automatic; second, because there is no self-interest to prevent overissues and maintain convertibility (as in our Civil War); third, because it may any hour bring us all the evils in the train of depreciated

paper, speculation, inflation, thirst for "more money," increase of government burdens, and overwhelming difficulties in returning to solvency again by contraction; fourth, because government issues are inelastic; and, fifth, because it puts the government in the dangerous position of trying to influence and control prices and the money markets. These are reasons enough for the withdrawal of the United States notes. But there should be no complex schemes for withdrawing them. Let them be funded in low-interest-bearing bonds.[1]

§ 7. The movement urging on the Baltimore Plan was soon merged in the general activity of business men which led to the Indianapolis Convention of January 12, 1897, and the appointment of the Monetary Commission of the same year. The outcome of that commission appeared directly in the act of March 14, 1900, chiefly concerned with the maintenance of the gold standard (as explained already in Chapter I). But its recommendations for the gradual withdrawal of the greenbacks, in connection with a revision of the issues by the banks, were not carried out. Although this act chronologically came after the proposals of the Baltimore Plan, it comes first in the evolution of thinking on money and banking and, therefore, is first disposed of in this volume.

The work of this commission, however, was directly concerned with a study of our banking system, the inelasticity of its issues, and it advocated at length in its final report (1898) measures aiming to substitute com-

[1] The main arguments presented against the Baltimore Plan were that it gave to the banks the power and right to create money; that this power belonged solely to the government, and that the banks would thereby be allowed to make money scarce or plentiful to their own gain. On this general argument see Laughlin, *Money and Prices*, chap. X, "Government vs. Bank Issues."

mercial paper for government bonds as security for bank-notes. The material presented in that report was widely studied and had no little influence on the thinking of that time. Its proposals were at first more or less unfamiliar to the public, and even to the rank and file of the banking profession, and yet in ten years its recommendations were practically all incorporated in the bill of the American Bankers' Association in 1908 and presented to Congress in that year.

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CHAPTER III

INFLUENCE OF THE PANIC OF 1907

§ 1. The intention in this chapter is not to give a general history of the panic of 1907, but only to show how the panic affected the evolution of thinking on banking and how the groping through the matters affecting notes and media of exchange led to the underlying problems of the organization of credit.

The inelasticity of our forms of money had by this time become a trite subject; but the conditions of the money market, which in the crisis of 1907 led to a general resort to clearing-house certificates throughout the country, brought a new interest in measures of reform. Obviously, a strong impetus was given to the discussion of an emergency issue by the national banks, and there was an evident determination to secure currency legislation from the next session of Congress.

As every one knew, our greenbacks (United States notes) and our silver circulation were fixed at a rigid limit, which could be neither increased nor diminished. The national bank notes were, also, inelastic, for all practical purposes. Therefore, of all our varied forms of lawful money, only gold was truly elastic. If we had too much we could send it to the arts, or ship it abroad; if we had too little, we could import from any market in the world on which we had credits. Finally, as had been displayed during the panic in an impressive manner, the only "currency" which is really elastic in every sense, and the only one to be resorted to when every other medium of exchange is unavailable, is the deposit-cur-

rency (checks drawn on deposits). While clearing-house certificates are in use only between banks, checks have become the general and efficient currency with which merchants meet their engagements both with individuals and the banks. If a borrower can get a loan, he can meet his maturing obligations effectively by the use of checks. In a crisis, therefore, the one important thing is getting the loan, and getting it in the form of a means of payment which his creditor will accept.

Yet, borrowers may in some cases require notes which can be used in paying wages, and in meeting the needs of retail trade, expenses of travel, and the like. In a crisis like that of 1907 this kind of a demand for money might have been adequately met by the issue of bank-notes; and the amount of lawful money in the pockets of the people might have been replaced safely by such notes. When frightened depositors drew and hoarded money, it was usually taken from lawful money reserves, and reduced the immediate power of the bank to lend under certain conditions by at least four times the sum of the withdrawals. Therefore, if those depositors could have been induced to accept bank-notes, instead of lawful money (gold and gold certificates, silver and silver certificates, greenbacks, and treasury notes of 1890), there would have been at hand a means of quieting the public alarm, and of preventing what was practically a general suspension of cash payments. To this extent the issue of an emergency circulation by the national banks would have had a salutary influence. There was here a field for bank-notes of unmistakable importance, which justified all the arguments in favor of new legislation, such as was proposed by the Fowler Bill, or by that of the American Bankers' Association.

A period of panic invariably enforced the necessity of

some marginal elasticity on the total circulation. Inability to obtain circulating notes for cash payments necessarily intensified the unfortunate conditions incident to a collapse of credit. In the summer of 1893 it was practically impossible to obtain a sufficient supply of a circulating medium of any kind. On June 1, 1893, the banks of New York held $21,000,000 in excess of their legal cash reserves. The national bank notes then outstanding were about $177,000,000. The exceptional demands for currency had drawn down the reserves of the New York banks, by August 1, $14,000,000 below the legal minimum. Yet the total of the national bank notes outstanding at that date had risen by only $5,000,000. By September 1, when the emergency had passed and currency was once more relatively abundant, the national bank notes had expanded to $199,800,000, and later rose by November 1 to $209,300,000.

The experience in the panic of 1907 was confirmatory. Then, the height of the crisis came in October. Every possible effort was made to increase the bank-note circulation, but to little effect. So scarce was currency that the clearing-houses in some cities issued certificates of small denominations to circulate as money in the hands of the public. On July 1 the circulation of the national banks was $603,788,690, but by October 31 it was only $609,980,466; while during November it had risen to $656,218,196, and by December 31 to $690,130,894. The bulk of this increase came too late to relieve the currency stringency. Furthermore, in the following months, when the clearings showed a decrease of over 28 per cent, and when the circulation should have declined correspondingly, the national bank notes actually increased by about $8,000,000. There was no elasticity by contraction when the need had passed by.

It resulted, also, from the panic of 1907 that a more liberal policy was introduced by the Treasury in regard to the deposit of bonds as security for public funds. It was found that nearly all the available government bonds had been deposited with the Treasury either to secure national bank notes, or deposits of public funds. This led to a release by the Treasury of government bonds behind public deposits with the banks, in order that more bonds could be used to secure bank-notes. Previously the Treasury had begun to accept other than government bonds as security for deposits.[1] Thus the public mind was gradually being prepared to think of other than government bonds as a safe security even for national bank notes.

§ 2. The public, however, seemed to be looking for more than this from coming legislation; to ask for an elastic currency, seasonal elasticity for crop movements, was not the only thing needed. It was hoped that a new currency law would give the means of averting the difficulties of a commercial crisis; but it is well to make clear that such a hope, if based solely on note-issues, was wholly elusive. There was more than one element in the situation which was then beyond the influence of legislation, present or future. In the first place, there was general agreement that the high rates of interest of that time, not only in the United States but in Europe, were due to a relative scarcity of capital. The prodigious development of our resources, and the expansion of opportunities for the use of capital here, had accompanied a more or less corresponding growth in

[1] In the act of March 4, 1907, sec. 3, it was said: "The Secretary of the Treasury shall require the associations thus designated [as depositaries] to give satisfactory security, by the deposit of United States bonds *and otherwise*, for the safe-keeping, etc."

Europe. In fact, events had emphasized the truth, which need not be enforced for economic students, that interest was primarily paid for capital, not for "money." If our banks had had abundant capital then, they would have had no difficulty whatever because of any lack of a medium of exchange in passing it over to railways, or to merchants, who wished to borrow. An entry in a deposit-account on which a check could be drawn would alone have served the purpose. In truth, there was no "scarcity of money" for carrying on exchanges other than those occasioned by the demands of pay-rolls, retail trade, and the like. The great need was for a loan; and the only real scarcity, so far as it concerned money, could have been only in the kind which was available for lawful reserves, and which affected the immediate ability of a bank to lend. In fact, there was no scarcity of gold in the world with which reserves could be increased; for the burden of recent discussions on gold has been an emphasis on the vast new production in increasing the level of prices. In short, the scarcity of lawful reserves in the banks, or the consequent limitation of loans, could have been directly traceable only to a lack of banking resources with which to buy enough gold to carry the growing burdens of trade, or to the fact that the investments of the bank's resources were in assets of a more or less speculative quality which could not be realized upon in an emergency. Therefore, to the extent that promotion schemes, or overtrading, formed the basis of bank loans we had a case of abnormal credit to deal with. The acceptance of questionable collateral is wholly a matter of banking judgment and it has nothing whatever to do with abundance or scarcity of money. Even if reserves were full, a bad loan would still remain a bad

loan. It is to be seen, then, that congressional legislation could not be expected to remedy any lack of capital, or to avert the effects of past misjudgment, or of folly, in accepting doubtful collateral.

It is highly important to disabuse the popular mind of the fallacy that the real difficulties of a crisis like that of 1907 could be removed by the issue of bank-notes. As has been repeatedly said, the crucial need, the one need important above all others, was that of obtaining a loan to meet maturing obligations or of continuing a loan already made. If banks, because collateral shrinks, or loans fall due, begin to call in loans, and refuse continuations, in order to build up their reserves, general liquidation and depression are at hand. The ability to lend is the crux of the whole matter; and other things are secondary to it. How true this is may be seen by the action of the Bank of England in a panic. While the act of 1844 has not saved the English from serious collapses of credit, its operation has disclosed the real source of trouble in the ease or difficulty of getting loans at the banking department. This difficulty did not primarily reside in a lack of money; nor was the increase in the rate of discount the cause of a direct increase in the charge for gold at the issue department. The high rate of discount affected only loans at the banking department, which is entirely independent of the issue department. When new loans are made by the former, the deposits are increased, and the percentage of reserves to deposits is lowered. And it is to be remembered that Bank of England notes are permitted in the banking reserves. If, in a crisis, a great pressure for loans developed, the bank—above all things—did not refuse to lend, even if its reserves were drawn down. Instead, the di-

rectors violated the law[1] at that time forbidding the issue of more than about sixteen and three-fourths millions of pounds on the security of government bonds; took bonds from the assets of the banking department to the issue department; got notes on the security of these bonds; and thereby replenished the lawful reserves of the banking department. This meant that all borrowers with satisfactory collateral could get loans. That fact once widely known stopped the rush for loans not absolutely imperative; and the alarm subsided.

The lessons from the previous discussion, as well as from the experiences of European banks, must be very plain. Nothing could be of any help to us in a crisis which did not aid the banks in lending to legitimate borrowers. Only in so far as assets could be used to obtain more lawful money—money which could be added to the reserves, and thus increase the power of the banks to relieve needy borrowers—could mere currency schemes be of any great use in a financial crisis. This truth could be fully appreciated by observing at that time the purchase of foreign gold by use of credits on Europe based on cotton or grain bills, or on the sale of our cheap securities. Here was one direct way of securing our lending power, and of supporting our commercial houses which needed an extension of loans; since changing assets into gold directly touched their immediate power to lend. The extraordinary decline of lawful reserves in the New York banks for the week ending November 9, 1907, to $51,000,000 below the legal limit, coupled with a large increase of loans, showed that the banks were doing the

[1] The power to disregard the limit fixed by the act of 1844 was on August 6, 1914, delegated to the Treasury; and the minimum of notes secured by bonds has risen to £18¾ millions. For the working of this system in the unequalled panic of 1914, on the outbreak of the European War, see Laughlin, *Credit of the Nations*, chap. III.

only wise thing—making necessary loans—and yet liberally furnishing actual cash to other parts of the country out of their reserves. The only question was whether the imports of foreign gold would overtake the withdrawals from the reserves.

The only other direct means, under the law of that day, was to collect greenbacks, silver, and treasury notes of 1890. The last had been almost eliminated; and the former two were rigidly fixed in amount. But, we heard on every side of a demand for more bank-notes. Would the issue of their own bank-notes, their demand-liabilities, increase the ability of the banks to lend? Evidently not. These notes could not be used in their reserves; nor should they ever be so allowed. In short, apart from protecting reserves from a drain, an elastic bank currency could not directly avert the essential difficulties of the situation. The supposed elasticity in a financial crisis was not, as is usually thought, a matter merely of more "money."

§ 3. In this connection, the plan of the American Bankers' Association[1] and that of the Fowler Bill should not be overlooked. These plans were on some points practically identical, and contained the following provisions:

1. Any national bank having been actively doing business for one year and having a surplus fund equal to 20 per cent of its capital shall have authority to issue credit notes as follows, subject to the rules and regulations to be fixed by the comptroller of the currency:

(*a*) An amount equal to 40 per cent of its bond-secured circulation, subject to a tax of 2½ per cent (3 per cent in the Fowler Bill) per annum upon the average amount outstanding.

[1] See *infra*, Appendix I.

(*b*) A further amount equal to 12½ per cent *of its capital,* subject to a tax at the rate of 5 per cent per annum upon the average amount outstanding in excess of the amount first mentioned.

2. The same reserves shall be carried against credit notes as are now required by law to be carried against deposits.

3. A 5 per cent guaranty fund for the redemption of the notes of a defaulting bank.

4. Numerous redemption offices in various parts of the country, to secure easy and quick redemption when desired.

5. The repeal or the modification of the act of July 12, 1882, limiting the withdrawal of notes to $3,000,000 in any one month.

It will be observed from these provisions (1) that the emergency circulation, in the issue of at least the first 40 per cent, was contingent upon the bank's previous issue of notes secured by government bonds. When we remember that the largest city banks had, as a rule, made little or no use of their right to issue notes, and that they had done their enormous business, earned their profits, and built up their huge surpluses, solely by the use of the deposit-currency, we shall see that were such legislation obtained the great banks of New York and other cities would not have been able in such a crisis as that of 1907 to issue any emergency notes to speak of.

Again, it is to be noted (2) that the same reserves of lawful money were to be maintained behind these emergency notes as behind ordinary demand-deposits. If this were enacted, and if there were a great pressure for loans from the business public, a bank would be just as much inhibited from granting a loan in the form of its notes as in the form of its deposits. In the case of any drain on its lawful reserves, it would be checked from lending in either form. The privilege to issue emergency notes would not, under such a law, aid the banks

in lending to legitimate borrowers, and therefore in averting the disasters due to weakened confidence, a run on cash reserves, or eventual liquidation. In short, so-called currency evils were not responsible for the crisis; nor would the legislation here proposed have met the essential needs created in a serious financial stringency. To have allowed the banks to increase their own evidences of debt would not have increased their reserves of lawful money, or their ability to lend.

§ 4. This examination of the proposed reforms of our currency ought not, however, to be regarded as an argument against the desirability of other and more advanced legislation. The reasons for wishing an elastic bank currency are good and sufficient in themselves; but they must not be used for supporting emergency notes as a real cure for the evils of such a financial crisis as that of 1907. In justice it should be repeated, on the other hand, that a quick issue of bank-notes during a time of threatened danger would be a great help in warding off assaults on the lawful reserves. Whenever depositors call for "money," and payments are made in the bank's own notes, for a time the public would be satisfied, and the lawful money reserves would be kept intact. Thus, the right to issue emergency notes would be a very useful device in protecting for a time the lawful reserves from depletion; and in a stringency of no great severity, the amount of such notes would prevent the evils of abnormal credit from doing much injury.

It was observed by Mr. Fowler that an enormous amount of lawful money was out in the hands of the people, which, if in the reserves of the banks, would beyond all question increase the power of the banks to lend. It is to be noted, however, that increased loans should

go with an increase of sound assets rather than with a mere enlargement of reserves. Obviously, the banks ought—under proper safeguards—to be allowed to issue notes in such denominations, and in such amounts as the public want them. That proposition would bring in, however, many important considerations, one of which was the treatment of our silver circulation. The act of 1900 particularly provided means by which the large silver certificates should be replaced by small denominations so as to secure their being kept out in the hands of the public. Hence, if it be argued—and there was a good ground for the argument—that the silver circulation should be displaced by small bank-notes, then the reform of our currency necessarily included the various forms of silver money. This made it clear that anything but a monetary *pis aller* should deal with more than our bank-note issue. Indeed, sooner or later, we had to face the larger questions in our currency shortcomings due to other than bank-issues. That 1908 was not the psychological hour for a real reform was later clearly seen.

If we were capable, in this country, of intelligently facing the problem of creating an efficient method of meeting, or mitigating, the inevitable dangers of a financial crisis, it was evident as early as 1908 that we should establish some institution wholly free from politics, or outside influence—as much respected for character and integrity as the supreme court—which would be able, in a great emergency, to use government bonds or selected assets as a basis for the issue of forms of lawful money which could be added to the reserves of the banks. Nothing else than this would meet the imperative need of loans. Bank-notes are not a legal tender between private persons; and could not be made into lawful re-

serves for the very issuers of the notes. It is doubtful if a great central bank—apart from its political impossibility—would accomplish the desired end. It is conceivable, however, that a commission (or board) of a high order, appointment to which would be a great honor, might, under general legislation, be competent to do for the United States what in effect the governor and directors of the Bank of England do for the English money market, when they create additions, under the advice and consent of the government, to the lawful reserves of the banking department.[1]

[1] This idea, expressed in 1907, was eventually embodied in the present Federal Reserve Board.

CHAPTER IV

THE ALDRICH-VREELAND ACT

§ 1. Although the Monetary Commission Bill of 1898[1] was advisedly intended to be a transition measure, retaining as a compromise a partial bond feature, the report presenting it had been leavening public opinion for many years. That presentation brought the subject before bankers and legislators for practical consideration. It will be interesting to watch how far it has colored succeeding legislation. As already said, the bill drawn up by the Currency Commission of the American Bankers' Association[2] in the early part of 1908 contained all the important provisions of the earlier bill. Likewise, the bills introduced at this time by Mr. Fowler, chairman of the House Banking Committee, although differing from the other plans in simplicity and in the means for carrying out the change from the old to the new system, were founded on the same general principles. Finally, the panic of 1907, as already explained in the preceding chapter, pricked public feeling into a demand for additional legislation on banking; and the politicians became firmly convinced, especially in view of the coming presidential campaign of 1908, that this public opinion must be satisfied by some kind of legislation. The consequence was the Aldrich-Vreeland Act (H. R. 21871) of May 30, 1908. It is a curious compound of conflicting views, compromise, haste, and politics; but it became

[1] See *Report of the Monetary Commission* (1898), pp. 60–74.

[2] See Appendix I.

the law of the land, and its provisions ought to be submitted to careful scrutiny.

The political considerations affecting the passage of the act are not all clearly explicable. The Republicans had played fast and loose with the money question in the past; and the Democrats had lost prestige, and two campaigns, by taking up silver. Neither party had been consistent. In early days, the Democratic party—as in the time of Benton and Jackson—advocated the gold standard and opposed a great central bank; but it forced the extinction of the Second United States Bank largely because it had tried to exact redemption for the State bank issues in the South and West. At the close of the Civil War the Democrats took up with the greenback craze, thus allowing their opponents to appeal to the business public as the champions of sound money. The Republicans passed the act of 1869 strengthening the public credit, passed the Resumption Act of 1875, and resumed specie payments, January 1, 1879. The victory over greenbackism and inflation was not an easy one; and when the Democrats introduced the silver mania as a substitute for greenbackism the Republicans wavered. The protectionists bought their legislation by votes for silver; and Republicans helped to pass the Bland-Allison Act of 1878. Moreover, they were chiefly responsible for the Sherman Act of 1890, which was followed by a panic and the repeal of silver purchases in 1893.

It was this departure of the Republican party from sound monetary policy—on the ground of expediency in catching votes—which gave the opportunity to the Democrats under the leadership of President Cleveland to outgeneral their opponents. By a stroke of political genius Cleveland manœuvred the Democrats into the

position of advantage formerly occupied by the Republicans, and restored to them their ancient advocacy of the gold standard. Then, for the first and only time since the Civil War, did the Democrats elect their candidate for President. Immediately thereafter a populistic wave overwhelmed the Democrats and carried them off under Bryan to the desert of silver and bank hostility. Their opposition to the gold standard, and their ignorant attitude on banking legislation, lost them the confidence of the electorate.

The Republicans, however, went right only by accident and expediency. The errors of their opponents showed them the pitfalls to avoid; but it was not an understanding of the monetary question nor a patriotic desire to give the business and industrial interests of our land a banking system best adapted to further domestic and international trade which actuated the policy of the Republicans. They had been on the fence; and they finally got down on the gold side only because they saw the Democrats struggling in the brambles on the silver side. They deliberately used the money question as a means of retaining political power and for years kept the business interests of the country on tenter-hooks for the sake of party advantage. It was not the favor of the business public, but the populism and wildness of the Democrats on money, which kept the Republicans in power. In 1900 the latter were unwilling fully to establish the gold standard in the act of March 14, 1900, by making our silver coins redeemable in gold, because they believed there was still a chance of preventing the discussion of the tariff, and retaining public support, by keeping the money issue open. This is an illustration of the price that industry pays to politics in a democracy.

Then, when the panic of 1907 forced the temporary

suspension of payments by banks from the Atlantic to the Pacific, and brought on an issue of clearing-house certificates and clearing-house currency in default of ordinary forms of money, the party in power felt that the unthinking voters would charge it with the responsibility for not having legislated in favor of an abundant circulation. The theory on which the supposed demand for legislation was based was that the panic was due to a scarcity of money. Of course, this specious reasoning was nothing more or less than the old argument of the greenbackers and the silverites. Yet with the politicians the point was not whether the theory was right or wrong; it was whether or not the theory was actually held by masses of voters who were to be cajoled.

In connection with the measures taken by the Treasury to meet the effects of the panic we heard from President Roosevelt and the politicians an emphasis upon the supposed aid which could be rendered by the issue of enormous sums of currency. Even the sale of Panama bonds and 3 per cent certificates was heralded by triumphant words of inflation as an addition to the currency. It matters little that these securities were not money; it was hoped to hoodwink the people. There seemed to be, in the matter sent out from Washington to the press, little understanding of the causes of the panic; in fact, the performances of the Treasury were the crudest in our monetary history—and that is saying a good deal. Having no policy as to monetary reform beyond that of political expediency, it was not to be expected that the Republicans would treat banking legislation on its merits. Here is the milk in the cocoanut. No legislation is to be had solely because an understanding of banking principles directs a specific reform; the political leaders in power do not have sufficient courage to do what is really

needed by the commercial public, provided enough whittlers on store-boxes at the country crossroads have other views as to what should be done.

The Democrats, as usual, took the populistic attitude in urging the issue of all notes by the government, and the withdrawal from the banks of the right to issue notes. Thereby, they fortunately gave the Republicans a political reason for favoring some legitimate or possible basis for the issue of notes by the banks. The question was: What basis should the Republicans adopt? That was the crux of the Aldrich-Vreeland Bill.

§ 2. In the session of Congress following the panic of 1907 the argument for new legislation contained the crude expectation that the law would prevent the possibility of future panics. This view was expressed both in a part of the press and in Congress, and showed little appreciation of the real causes at work in an inflation of credit. In the Senate, where the members of the Finance Committee, under the leadership of Senator Aldrich, were also the practical rulers of the Republican party, a stern opposition was early expressed against any form of "asset-currency," and this policy had the support of the President. Evidently, the Republican politicians believed that the issue of notes by banks on other security than bonds would expose their party to attacks in the next campaign which they, in their general incapacity on banking questions, would not be able to meet successfully. They could not see that elasticity, ready expansion of the currency in time of need, and lower rates of interest to borrowers might be popular issues with the people in any campaign.

Also, no doubt, there was a conviction in the minds of many senators that "asset-currency" was synonymous

with "wildcat currency" and involved the dangers of uncontrollable abuses by excessive issues. It is needless to say that those dangers do not inhere in any legitimate system of "asset-currency," as was amply proved by its use in the chief commercial countries of Europe; but it is interesting to note that leaders—ignorant of banking and openly flouting the advice of trained bankers—produced in the Senate Aldrich Bill a plan for notes issued on bonds of a kind as like those of "wildcat currency" days as any two peas. Looking at the matter solely as politics, it is difficult to understand why the Senate stubbornly thought it possible to gain votes by antagonizing the very commercial bodies and banking interests who were most competent to judge of such matters. It is a matter of curious interest to know why there was political capital to be gained from urging a bond-secured system of note-issues which had long been known to have been outgrown, rigid, inelastic, hurtful to country districts, and of little advantage to large city banks which make comparatively small use of the issue-function. The bond-secured system lent itself to such easy and popular attacks that, as a political move, it proved a great blunder. When the Aldrich Bill came down from the Senate it was thoroughly riddled in the House by the representatives of industry and banking who appeared before the Banking Committee; and in the House, which much more nearly represented the opinions of the public than the Senate, it was overwhelmingly defeated. One can scarcely avoid the conclusion that the Aldrich Bill represented only the stolid personal prejudices of a very few mistaken politicians who held the reins of power.

On January 7, 1908, Mr. Aldrich introduced his bill (S. 3023), and it was reported out by the Committee on

Finance with amendments, January 30, 1908. Later, before passing the Senate, some radical amendments were added, to meet the views of such men as Senator LaFollette (*e. g.*, sec. 11). The original Aldrich Bill permitted a national bank, having an outstanding circulation secured by United States bonds to an amount not less than 50 per cent of its capital, and which had a surplus of 20 per cent, to issue additional circulation secured by bonds other than bonds of the United States. These other bonds were as follows:

> Bonds or other interest-bearing obligations of any State of the United States, or any legally authorized bonds issued by any city, town, county, or other legally constituted municipality or district in the United States which has been in existence for a period of ten years, and which for a period of ten years previous to such deposit has not defaulted in the payment of any part of either principal or interest of any funded debt authorized to be contracted by it, and whose net funded indebtedness does not exceed ten per centum of the valuation of its taxable property, to be ascertained by the last preceding valuation of property for the assessment of taxes; or the first mortgage bonds of any railway company, which, in compliance with existing law, reports regularly to the Interstate Commerce Commission a statement of its condition and earnings, and which has paid dividends of not less than four per centum per annum regularly and continuously on its entire capital stock for a period of not less than five years previous to the deposit of bonds.

Notes secured by other than United States bonds could be issued on the approval of the secretary of the treasury to an amount, if by railway bonds, equal to 75 per cent, and if by other bonds, to 90 per cent of their market value. The limit of notes issued by a bank was the amount of its capital and surplus; and the total of this additional circulation issued by all the banks was to be

$500,000,000. To allow contraction, United States bonds could be withdrawn by the deposit of lawful money; other than United States bonds, by the deposit of lawful money or national bank notes. The notes were to carry on their face a pledge of the United States that they would be redeemed on presentation in lawful money. A tax of ½ of 1 per cent was levied on the notes, if secured by United States bonds bearing less than 2 per cent interest; 1 per cent, if the United States bonds bore more than 2 per cent; and 1 per cent, if the bonds were other than United States bonds. The Aldrich Bill was amended so as to include the bonds of Porto Rico and the Philippine Islands, but to exclude American railway bonds. It passed the Senate (March 27) and was referred in the House to the Committee on Banking and Currency, March 30, 1908.

As opposed to this Senate measure was the Fowler Bill, reported from the Banking Committee to the House. The original Fowler Bill (H. R. 23017, Fifty-ninth Congress, Second Session) introduced December 20, 1906, in the main had the support of the bankers. This bill followed the general plan of the Monetary Commission of 1898, but proposed a gradual change from notes secured by United States bonds to notes secured by commercial assets. According to it, "National Bank Guaranteed Credit Notes," equal to 40 per cent of the notes issued by a bank secured by United States bonds, and not exceeding 25 per cent of its capital, could be issued without the deposit of any United States or other bonds. Such notes to pay a tax of 3 per cent. An additional amount of notes equal to 12½ per cent of the capital could be issued by paying a tax of 5 per cent. The outside limit was the amount of the capital. The holder of these credit notes was to be a general creditor of the

issuing bank. A guaranty fund of 5 per cent of the credit notes was established, and all taxes on circulation were to be covered into this fund. Additional redemption cities were required.

In the next session of Congress (Sixtieth Congress, First Session) Mr. Fowler introduced another bill (H. R. 12677), January 8, 1908, and it was reported out by the Committee on Banking and Currency, February 29, 1908. In this later bill Mr. Fowler seemed to have lost the support of the American Bankers' Association; and, of course, the administration and the leaders in Congress who favored a bond-secured circulation opposed it. His measure went to extremes, and included many other than banking schemes. While some of the additions, excepting the guaranty of deposits, were meritorious, Congress and the public wished to act on only one thing at a time. This bill (H. R. 12677) urged the creation of not more than twenty bank redemption districts, controlled by eight managers and a deputy comptroller, and within which each bank should select a redemption centre for its notes. Its refusal of all compromise appeared in its allowing a bank at once to retire all its notes secured by United States bonds and replace them with notes, not secured by bonds of any kind, to a limit equal to its capital; provided the bank had arranged for the redemption of its notes in gold at a redemption centre, and had deposited with the Treasury in gold, or lawful money, 5 per cent of its notes, and 5 per cent of its deposits, as guaranty funds. If the district managers approved, a bank might issue an additional amount of notes equal to 100 per cent of its capital. Such notes would have a distinctive color, and state on their face that they were redeemable in coin and guaranteed by a fund deposited with the Treasury. After January 1, 1909, no notes se-

cured by bonds were to be paid out. Banks were to pay 2 per cent interest on government deposits, and to be freed from giving bonds as security for deposits. The notes to be taxed 1 per cent. In addition the measure contained provisions for a guaranty of deposits, for enabling national banks to do a trust business, for abolishing the independent treasury system, and for the eventual retirement of the greenbacks.

It soon became evident that, while the House would pass a bill permitting a trial of commercial assets as a basis for note-issues, it was not ready to throw over all bond security; and also that the House would not pass the Aldrich Bill. Hence, both the Aldrich and the Fowler Bills were impossible. Yet the political managers were firm in the belief that some banking bill was obligatory in view of the recent panic. A caucus of the Republican party in the House appointed a committee, including Mr. Vreeland (New York) and Mr. Burton (Ohio) but excluding Mr. Fowler, the chairman of the Banking Committee, to frame the bill. Mr. Fowler had incurred the hostility of the administration and of the leaders of the House and Senate, and was officially ignored. This caucus bill, not being based on any purpose to touch the real merits of the problem, was wrung from the politicians by force of events.

Two bills (H. R. 21810 and H. R. 21871) were introduced by Mr. Vreeland on May 11 and May 12, 1908. They differed only in slight matters, except that the later bill changed the words to be printed on the notes. Redemption by the United States was dropped out, and the words of the act as finally enacted were introduced. Knowing this measure to be inspired by those who had the power to enact it, its provisions were of importance: National clearing-house associations, made up of not less

than ten banks having an aggregate capital and surplus of at least $5,000,000 were created, to be managed by a board having one representative from each bank and given the power to issue additional notes based on "any securities, including commercial paper, held by a national banking association," provided the given bank already had outstanding notes secured by United States bonds to an amount not less than 40 per cent of its capital. Notes were limited to 75 per cent of the cash value of the securities, or of the commercial paper. These notes were a lien on all the assets of all the banks in the given currency association issuing the notes. The limit of the issues of any one bank was its capital and surplus; and the aggregate of the additional issues (not based on United States bonds) was $500,000,000. Banks must hold the same reserves behind the emergency circulation as for deposits; notes secured by 2 per cent United States bonds to pay a tax of ½ of 1 per cent; if bearing more than 2 per cent, a tax of 1 per cent; if secured through clearing-house associations (*i. e.*, on commercial paper, etc.), a tax of 4 per cent, increasing monthly by 1 per cent, until 10 per cent was reached; these taxes to be covered into the general funds of the Treasury. Notes secured by United States bonds could be withdrawn at a rate not exceeding $9,000,000 a month; if otherwise secured, no such limit was imposed. The directions as to the wording on the notes were as follows:

> Such notes shall state upon their face that they are secured by United States bonds or other securities according to law, shall be certified by the written or engraved signatures of the Treasurer and Register, and by the imprint of the seal of the Treasury. They shall also express upon their face the promise of the banking association receiving the same to pay on demand, etc.

Whenever these notes were presented to the Treasury for redemption, they should be redeemed in lawful money. Finally, a National Currency Commission was to be appointed, having six senators, six representatives, and six others, to investigate "the causes of the recent financial crisis," and to make recommendations in a report by January 1, 1909. It is worth noting that in the final enactment the commission was relieved from explaining the causes of the panic.

Mr. Fowler, not to be repressed, introduced his bill again, May 4, 1908, shorn of its extreme provisions. Accepting a requirement that a bank should already have notes outstanding secured by United States bonds equal to 50 per cent of its capital, it could then issue 50 per cent more not secured by bonds; and in an emergency an additional sum equal to 100 per cent of its capital and surplus, with the consent of district managers and the comptroller. On January 1, 1909, however, all notes secured by United States bonds were to be cancelled. The provisions for guaranty of deposits, trust business, abolition of the greenbacks and the subtreasury were dropped.

This bill, favored by many, was rudely set aside and the Vreeland Caucus Bill was passed in the House by a large majority. The Senate refused to accept it, the Aldrich Bill was substituted, and the matter was finally referred to a conference committee of both Houses. After considerable struggle in conference, in which much of the Aldrich Bill was introduced into the Vreeland Bill, the Aldrich-Vreeland Bill was reported to both Houses in the last days of the session, and hurriedly passed under the party lash, May 30, 1908. It was passed before printed copies of the bill were distributed.

Like most political measures, which look both ways

and try to conciliate conflicting interests, the Aldrich-Vreeland Act contained many inconsistencies. On the one hand, it catered to a supposed public opinion among the masses against "asset-currency"; and on the other hand, it aimed to win the eager support of the influential classes owning or marketing the great volume of financial securities. By inserting much of the Aldrich Bill into the Vreeland Bill in the Conference Committee, the bond interests evidently won a great victory. Nevertheless, in view of the evident desire to play politics and win the most votes, it is almost inconceivable that the exceptional favors to holders of market securities should have been regarded as good politics, especially as the measure at the same time alienated large banking and commercial interests.

§ 3. This Aldrich-Vreeland Act, emerging from such political conditions, was entered on the statute-books. It is therefore important as a part of our banking history to know just what its provisions were. It is evident, from the start, that the haste with which it was pushed through Congress must have made careful legislation impossible. In some quarters[1] it was heralded as a great triumph of Republican monetary policy; and in other quarters it was regarded as bad in theory, and a cheat, because it was offered as a compromise to asset-currency advocates in a form greatly minimizing what it was said to offer. Certainly the law was a failure, if it was expected to quiet the urgent demand for real banking reform; and the political gains were far to seek.

One evident purpose of the law was to remove in the future the inability of the banks to increase their note-

[1] Theodore Gilman, "The Aldrich-Vreeland Bill," *North American Review*, August, 1908.

issues in an emergency such as was disclosed in the panic of 1907. And it must be admitted that in a measure this end was accomplished, although by means which proved to be clumsy and not foreseen by the framers of the law. The act enabled a bank which had already outstanding notes secured by United States bonds to an amount equal to 40 per cent of its capital, and which had a surplus of 20 per cent, to take out additional circulation either (1) on certain bonds other than United States bonds, or (2) on any securities, including commercial paper, held by a national banking association. In (1) the bank can deal directly as an individual with the Treasury. In (2) the bank must act through a national currency association created by this law.

The preliminary requirement that no bank could issue additional circulation unless it had already outstanding notes secured by United States bonds equal to 40 per cent of its capital was one that created serious difficulties. It was a part of the persistent adherence to a bond-secured note-issue; and was supposed to be a measure of a transitional character on the way to some new basis of security. This provision, however, seemed to ignore the character of the business done by the largest city banks. In the past their loan and deposit functions had been chiefly exercised through checks on deposits, and actual notes had been little called for in large transactions. Possibly the needs of country correspondents may have increased somewhat an otherwise small issue of notes by banks of the largest size; but only in the panic of 1907 had these large banks resorted to any considerable issue of notes. Therefore, if there should be a general desire to put themselves in a position to issue additional notes under this new act, the banks, under the necessity of first issuing 40 per cent of bond-secured notes,

would certainly greatly increase the demand for United States bonds. July 31, 1908, there were deposited to secure circulating notes United States bonds to the amount of $629,432,420; and to secure public deposits, $145,869,-372; while the total issue of bonds outstanding (including $14,086,500, 3 per cent certificates of indebtedness issued November, 1907) June 20, 1908, was $897,503,990. There was thus very little leeway for increasing notes secured by United States bonds, in view of the considerable amounts of these bonds held permanently by private investors. Now it was for the very reason that these bonds were high and scarce—how scarce could well be appreciated by those who tried to borrow them in the crisis of 1907—that the banking system required overhauling. And yet the first effect of the act was to send up the price of government bonds, already perhaps 20 points higher than they would be but for the demand for them as security for bank-notes. It was a serious question whether the obstacle of a large previous investment in United States bonds would not prevent the hoped-for ease of expansion in times of emergency. It would certainly be a heavy handicap; and it was one more illustration of the failure of the act to meet the real difficulties of the existing banking situation. If an emergency were to arise, the banks would no doubt be obliged to resort, as before, to the issue of clearing-house certificates.

§ 4. In case a bank had satisfied the requirement as regards circulation based on United States bonds, then it could (1) secure additional circulation based on other than United States bonds, by making application directly to the comptroller of the currency, and without the intervention of any currency association. Notes could be issued to the amount of 90 per cent of the market value

of these bonds, and were limited, all told, to the amount of a bank's capital and surplus. The kind of bonds allowed was clearly described (sec. 3) as follows:

> Bonds or other interest-bearing obligations of any state of the United States, or any legally authorized bonds issued by any city, town, county, or other legally constituted municipality or district in the United States which has been in existence for a period of ten years, and which for a period of ten years previous to such deposit has not defaulted in the payment of any part of either principal or interest of any funded debt authorized to be contracted by it, and whose net funded indebtedness does not exceed ten per centum of the valuation of its taxable property, to be ascertained by the last preceding valuation of property for the assessment of taxes.

But, (2) should a bank wish to make use of its commercial assets as a basis for its circulation, it must act through a national currency association. Such a voluntary association, modelled somewhat after the plan of a clearing-house association, must contain not less than ten banks, having an aggregate capital and surplus of at least $5,000,000. To it was given legal corporate powers. Only one association could be formed in any one city; and no bank could belong to more than one association. The banks must be taken from contiguous territory. Any duly qualified bank, on application to the secretary, could force its entrance into an association, and have all the rights of an original member. Thus, banks in New Jersey or Connecticut could insist on membership in the association of New York City, under the literal interpretation of "contiguous territory" given by Secretary Cortelyou. An association was governed by a board consisting of one representative from each bank. Thus a bank with a capital of $25,000 had equal influence with one having a capital of $25,000,000, and it was discov-

ered that no provision existed in the law by which a bank having once entered could ever withdraw from an association. This evidence of carelessness in drawing up the act caused great hesitation and delay in the formation of associations. In October, 1908, that in Washington, D. C., was the only one formed.[1] Influential banks, held jointly liable with small banks for the redemption of any notes authorized by the association, were slow to enter a combination from which they could not withdraw in case of bad management. Once in, a bank could not, during the six years of the act, withdraw even in order to take out notes as an independent bank dealing directly with the comptroller. This awkward situation was certain to call out an amendment.

§ 5. Supposing the difficulties connected with the forming of currency associations and the investment in United States bonds were surmounted, then we would be face to face with the new methods of issuing additional notes based on banking paper. The provisions concerned with the basis of security were so pivotal, and so likely to be differently interpreted, that it is well to quote them herewith. Indeed, the greatest surprise of the act is probably to be found in the crudeness, or haste, with which the law was framed on these points:

Sec. 1. The national currency association herein provided for shall have and exercise any and *all powers necessary* to carry out the purposes of this section, namely, *to render available*, under the direction and control of the Secretary of the Treasury, as a basis for additional circulation *any securities, including commercial paper, held by a national banking association*. For the purpose of obtaining such additional circulation, any bank

[1] Later, on the urgent request of Secretary MacVeagh, many associations were reluctantly formed. *Cf.* Chapter VIII, § 1.

belonging to any national currency association, having circulating notes outstanding secured by the deposit of bonds of the United States to an amount not less than 40 per centum of its capital stock, and which has its capital unimpaired and a surplus of not less than 20 per centum, may deposit with and transfer to the association, in trust for the United States, for the purpose hereinafter provided, *such of the securities above mentioned as may be satisfactory to the board of the association.* The officers of the association may thereupon, in behalf of such bank, make application to the Comptroller of the Currency for an issue of additional circulating notes to an amount not exceeding 75 per centum of the cash value of the securities or commercial paper so deposited. The Comptroller of the Currency shall immediately transmit such application to the Secretary of the Treasury with such recommendation as he thinks proper, and if, in the judgment of the Secretary of the Treasury, business conditions in the locality demand additional circulation, and *if he be satisfied with the character and value of the securities* proposed and that a lien in favor of the United States on the securities so deposited and on the assets of the banks composing the association will be amply sufficient for the protection of the United States, he may direct an issue of additional circulating notes to the association, on behalf of such bank, to an amount in his discretion, not, however, exceeding 75 per centum of the cash value of the securities so deposited: *Provided*, That upon the deposit of any of the State, city, town, county, or other municipal bonds, of a character described in section three of this Act, circulating notes may be issued to the extent of not exceeding 90 per centum of the market value of such bonds so deposited; *And provided further*, That no national banking association shall be authorized in any event to issue circulating notes based on commercial paper in excess of 30 per centum of its unimpaired capital and surplus. The term "commercial paper" shall be held to include only *notes representing actual commercial transactions, which* when accepted by the association *shall bear the names of at least two responsible parties and have not exceeding four months to run.*

In these words we have the final outcome of the whole struggle between those in favor of securing notes only by

bonds and those in favor of securing them by commercial assets. If United States bonds were no longer to be the sole security, then the system of a bond-secured circulation was to be retained, but by accepting other than United States bonds as a basis. This was the policy of the Aldrich Bill. Senator Aldrich opposed absolutely any issue of notes based on the current assets of banks, and insisted on a bond-secured currency, or nothing. Only when the House leaders were unable to pass the Aldrich Bill in the House, as already explained; when it looked as if the party must go before the country confessing its impotence to pass any kind of a banking law; and only when some recognition of commercial assets as security became essential to the passage of a bill through the House, did Senator Aldrich reluctantly yield. Even then he seemingly intended to restrict the use of bank assets within the lowest possible limits. Possibly he thought he had allowed only "commercial paper," as specifically defined in the act, to be used as security, together with other than United States bonds. Then it was that Mr. Vreeland drew up his bill, with an evident understanding with the Senate leaders on this point. In fact, the wording of the Vreeland Bill on this matter was the same as the wording of the act which was the final outcome of the conference between the two Houses.

We have here, however, what undoubtedly proved a surprise to the banking public, who naturally supposed that the law incorporated the purport of the compromise. As a matter of fact, the supposed intention of Senator Aldrich was not expressed in the law as passed, whether from conscious intent, or ignorance of English, or of the character of banking paper, it is hard to say. But it is unlikely that so astute a politician did not fully know

what he was doing. Moreover, the manner of making the error was possibly due to his zeal in trying to include railway bonds in the general class of those other than United States bonds. It will be remembered that the Aldrich Bill included in this class

> the first-mortgage bonds of any railroad company, which, in compliance with existing law, reports regularly to the Interstate Commerce Association a statement of its condition and earnings, and which has paid dividends of not less than 4 per centum per annum regularly and continuously on its entire capital stock for a period of not less than five years previous to the deposit of the bonds (Section 2).

Owing to the political clamor against the railways, Senator Aldrich had to see this provision expunged from his bill. But when the bills of the two Houses were in conference, it was possibly not noticed that the original phraseology of the Vreeland Bill, and that finally enacted, allowed "any securities, including commercial paper, held by a banking association" to be used as security under the direction of the secretary of the treasury. "Any securities" included not only first mortgage railway bonds, but any of the $16,000,000,000 of railway securities which might be held by any banking association, and accepted by the secretary. Nor were any reports to the Interstate Commerce Commission made necessary, nor the payment of dividends, as mentioned in the Aldrich Bill. And soon the secretary was confronted with the awful responsibility of deciding which of all these multifarious railway securities he ought to accept. It was a condition of things highly satisfactory to politicians and to bond dealers. If a security was accepted by the secretary every national bank would be informed that it was a good security for bank-notes. Such action would

give a bond or stock a valuable indorsement and greatly enhance its value. It opened up unlimited possibilities for pressure. It was an intolerable and an unforeseen situation.

But the inclusion of railway securities by the words "any securities" really introduced the greatest surprise of all into the new law. Without a shadow of doubt the language used was so broad and sweeping that it allowed the banks to offer any assets held by them, other than "commercial paper," as specifically defined in the act, and to which it was generally supposed the banks were limited. The very pains taken to define "commercial paper" would lead one to suppose that only that description of paper would be accepted. Such, however, was not the law. The act, as already quoted, runs as follows:

> The national currency association herein provided for shall have and exercise any and all powers necessary to carry out the purposes of this section, namely, to render available, under the direction and control of the Secretary of the Treasury, as a basis for additional circulation *any securities*, including commercial paper, held by a national banking association.

The powers here granted were sweeping; and the purpose of granting these large powers was defined to be: to render available as a basis for additional circulation any securities (including one specified kind) held by a national bank. The words "any securities" were used as a general or generic term, covering not only bonds, but such securities as commercial paper. Obviously, as the language runs, the words included anything other than "commercial paper" which could properly be included under the term "any securities." The interpretation hinges upon the meaning of the word "securities." In the accounts of the Bank of England the term

employed to cover all loans to customers is "other securities." In fact, in American banking usage, the word securities is commonly applied to any of the notes, collateral, or other paper, held to secure the repayment of a loan. It is a generic term.

The word "securities" was possibly not used with precision in the act. Clearly, it was not intended to be made synonymous only with bonds. Probably it was purposely left ambiguous. After making the general statement about "any securities, including commercial paper," the act speaks of the deposit, in trust for the United States, of "such of the securities above mentioned as may be satisfactory to the board of the association." Here securities include, of course, commercial paper. Again, in sec. 1, the word appears generically as follows:

> If he [the Secretary] be satisfied with the character and value of the securities proposed, and that a lien in favor of the United States on *the securities so deposited* and on the assets of the banks composing the association will be amply sufficient for the protection of the United States, etc.

Here, the context shows that the word "securities" includes the discounted bank paper on which notes could be issued only to 75 per centum of "the cash value of the securities so deposited"; for this amount of 75 per centum is put in opposition to the 90 per centum of notes to be issued, if the basis furnished is made up only of bonds.

Again in sec. 9, in regard to the tax, it is said:

> National banking associations having circulating notes secured otherwise than by bonds of the United States shall pay for the first month a tax at the rate of 5 per centum per annum upon the average amount of such of their notes in circulation as are based upon the deposit of such securities, and afterwards

an additional tax of 1 per centum per annum for each month until a tax of 10 per centum per annum is reached, and thereafter such tax of 10 per centum per annum, upon the average amount of such notes. Every national banking association having outstanding circulating notes secured by a deposit of other securities than United States bonds shall make monthly returns, under oath of its president or cashier, to the Treasurer of the United States, in such form as the Treasurer may prescribe, of the average monthly amount of its notes so secured in circulation; and it shall be the duty of the Comptroller of the Currency to cause such reports of notes in circulation to be verified by examination of the banks' records. The taxes received on circulating notes secured otherwise than by bonds of the United States shall be paid into the Division of Redemption of the Treasury and credited and added to the reserve fund held for the redemption of United States and other notes.

Obviously, the tax is the same on notes based on bonds other than United States bonds, and on commercial paper. If so, the word "securities" was used generically to include both kinds of protection to the notes.

The act, then, permitted the issue of notes on (1) United States bonds, (2) on approved bonds other than United States bonds, and (3) on "any securities, including commercial paper, held by a national banking association." It distinctly did not confine the issue of notes under (3) only to commercial paper—although it defined commercial paper specifically; and although it provided, in sec. 1:

That no national banking association shall be authorized in any event to issue circulating notes based on commercial paper in excess of 30 per centum of its unimpaired capital and surplus.

What then was the meaning of "any securities," other than "commercial paper"? Possibly Congress meant to separate the class of bonds distinctly from the class of "commercial paper," and to use securities only as a

synonym for bonds. Under this supposition, notes could be based only on (1) United States bonds, (2) other approved bonds, and (3) commercial paper, as defined. If, however, this was the intention, it was certainly not so expressed in the law. For, as we have seen, "securities" were not synonymous with bonds; and any securities other than bonds were permitted, including "commercial paper."

Why, then, was commercial paper defined, and the issues based upon them limited to 30 per cent of the capital and surplus? The definition is as follows:

> The term "commercial paper" shall be held to include only notes representing actual commercial transactions, which when accepted by the association shall bear the names of at least two responsible parties and have not exceeding four months to run.

Possibly, it was the intent of Congress that the only bank assets on which notes could be based was commercial paper; but, irrespective of this definition and of the 30 per cent clause, a currency association was given "any and all powers necessary . . . to render available . . . as a basis for additional circulation *any securities, including commercial paper, held by a national banking association*." As the law stood, if the association was limited to 30 per cent of its capital and surplus, when presenting "commercial paper," it was not so limited if it presented other bank paper not classifiable as "commercial" under the definition. In truth, those assets of a bank which did not come under the definition of "commercial paper" were given more liberal treatment than "commercial paper," and were placed outside of the operation of the 30 per cent clause.

Undoubtedly, some members of Congress must have

thought they had shut off the issue of notes on all assets (exclusive of government, or other bonds), except commercial paper. They probably wanted to distinguish between "accommodation paper," or "finance bills," on the one side, and legitimate commercial paper, on the other. But the sweeping general clauses of the act did not confine the securities other than bonds to commercial paper, as defined in the act. The wording of the law left the gates wide open for the deposit of any securities (*i. e.*, any kind of paper) held by a national bank, and offered by a currency association, subject only to "the direction and control of the Secretary of the Treasury." At least, that is the only possible interpretation which, in my opinion, would be given by the courts. And these are the reasons for the previous statement that the law provided the means for a large expansion of notes in a time of emergency—a freedom quite unexpected even by advocates of "asset-currency." Moreover, the House was put in control of the situation; for, if an attempt had been made by the Senate to amend its mistakes, the House, in which there was a majority against bond-secured circulation, could have retained the law as it stood. Any repeal or amendment required the consent of the House. This was certainly a startling outcome of the currency struggle.

The new law introduced some difficulties before additional notes could be issued; but after that point was reached, the gates were certainly left wide open. In case of another panic such as that of 1907, the scramble for currency would be avoided, the reserves more or less protected, the resort to clearing-house checks for currency in daily use prevented, and a sense of insecurity due to inability to get currency would be removed, were this Aldrich-Vreeland Act—as interpreted above—then

in force.[1] Of course, it could not prevent a future panic. No act could do that.

In addition, the notes were perfectly safe. The banks must keep in the redemption fund (sec. 6) a sum equal to 5 per cent of its additional circulation (other than that based on United States bonds), as distinct from the original 5 per cent redemption fund of June 20, 1874. Thus for immediate redemption it would seem that for notes secured by United States bonds, only 5 per cent was required, but for all notes otherwise secured, 10 per cent. The Treasury was obliged to redeem the notes; but, besides the securities deposited, the Treasury could have recourse to all the assets of all the banks in a currency association. The taxes paid, moreover, were to be turned into the division of redemption and added to the reserve fund held for the redemption of United States and other notes, thus constituting a potential safety fund in the future.

Also, banks had to pay a uniform rate of interest throughout the country of at least 1 per cent on government deposits; but no reserves were to be held against such deposits. Nor were any reserves against notes required.

§ 6. The Aldrich-Vreeland Act in its attempt to define "commercial paper," thus opened up the whole question as to the nature and classification of banking assets. The contemptuous rejection by the leaders of all advice from bankers undoubtedly got the framers of the law into unsuspected difficulties.

If only "commercial paper" as defined in the act were accepted, then there would have been excluded all loans based on legitimate transactions bearing only one name.

[1] *Cf.* the experience in the panic of 1914. Chapter XI, § 7.

Thus the one-name notes of a great merchant, or the U. S. Steel Corporation, would be excluded. The sale of goods would thus be no basis for a discount, unless such a firm went out and obtained an additional name. Such a discrimination was not only unfair, but it ignored the actual trade methods used in this country.

Practically, the only way in which two-name paper, based on actual transactions, is presented for discount in this country, is that in which so-called "trade-paper" is created. When a merchant buys goods in the United States on time, he receives a greater or less discount for paying cash before the account is due. This discount varies in different trades. In groceries, food products, etc., the sales are usually on 10 days time, and the discounts play no real part. In the sale of luxuries, such as fine millinery, or jewelry, the period allowed for payment of goods may be 6 months. But in trades like hardware, the time runs from 30 to 90 days. Hence, if a discount of 3 per cent is allowed by the seller, provided cash is paid in 10 days on goods sold at 90 days credit, that is equivalent to 3 per cent for 80 days, or at a rate of 13½ per cent per annum. Likewise, a discount of 2 per cent for cash paid in 30 days is equal to 12 per cent per annum. Now, if the buyer has good standing he can borrow at 4 or 5 per cent, and pay off his account, thereby saving the difference between 4 or 5 and 12 or 13½ per cent. The longer the time on which goods are sold, the larger the discounts and the greater the inducement to borrow and to anticipate payment of the account. Consequently, the merchants having the best credit never wait until their accounts mature; some of poorer credit meet payment at maturity; and others, not able to pay when the accounts fall due, must borrow and meet one indebtedness by creating a new one. Now, this last

class, the poorest of all, creates two-name paper, based on actual transactions, on less than 4 months time usually, which would be technically acceptable as "commercial paper" security for note-issues; while the paper of the men of higher credit, who can always borrow and save on the trade discounts, would not be acceptable. The framers of the act were lamentably ignorant of American trade methods and the nature of banking paper. In fact, the definition of "commercial paper" pivoted mainly on the requirements of two names. But it is obvious that this requirement would rule out some of the best paper held by banks.

In order to get a clear idea of the kind of assets held by national banks, having chiefly a mercantile clientèle, the following classification given to the comptroller by a certain well-managed bank will give us the average condition of such institutions:

A.	On demand, paper with one or more individual or firm names	$2,231,184.06
B.	On demand, secured by stocks, bonds, and other personal securities	4,063,083.61
C.	On time, paper with two or more individual or firm names	8,350,629.34
D.	On time, single-name paper, one person or firm without other security	9,497,384.44
E.	On time, secured by stocks, bonds, and other personal securities	5,604,183.75
F.	Secured by real estate, mortgages, or other lien on real estate	28,820.00
		$29,775,285.20

Apparently, according to the definition in the Aldrich-Vreeland Act of the paper allowable as security for notes, through currency associations, only class C could be accepted, and only that part which could be strictly construed as based on actual transactions. Yet, according

to bankers, this is not as a rule the best banking paper held.

As every one knows, also, the banks dealing mainly in loans of a mercantile character are large buyers of paper sold by note-brokers. Such notes are rarely secured by collateral, and usually bear one name. In the case of large corporations the indorsement of more than one officer of the company could not make two-name paper. In spite of some faults in such loans—doubtless remediable—the extent of the dependence on note-brokers is widespread. The situation is well expressed by a prominent banker[1] as follows:

> The ease with which loans are obtainable in normal times by responsible houses on their own direct, unsecured obligations, through the agency of note-brokers, has nearly done away with trade-paper [*i. e.*, two-name commercial paper] of the highest grade. All good concerns and many even in second and third grade credit are enabled to borrow all the funds required to take advantage of trade discounts, and enough more to meet all other bills at maturity, so there is little or no reason to settle trade accounts by notes. . . . No house can habitually do so without ultimate damage to its credit. The business of the note-broker in directly supplying capital when needed by solvent borrowers for production use in trade is comparatively a modern occupation, and it is highly beneficial if confined within legitimate and prudent limits. In this country the business has developed enormously within two or three decades and along lines that were unthought of a few years ago and which then would have been deemed impossible and extremely hazardous. The system as we know it is not in common practice anywhere else in the world.

All such paper obviously would be excluded by the legal definition of "commercial paper" in this act.

[1] Joseph T. Talbert, president of the Chicago Clearing-House, "Commercial Credits," an address before the New York State Bankers' Association, July 10, 1908.

The loans of modern banks are, of course, of all kinds; but a rough division may be made as follows: (1) loans to customers of a mercantile character; (2) notes purchased of note-brokers, and (3) loans to stock-brokers and individuals. The last class (3) are usually demand loans, and are generally fully secured and usually quite safe, being margined on quickly salable securities. Therefore, if only "commercial paper," as defined, were accepted as security for notes, classes (2) and (3) and a large part of (1) would be refused. Yet, in the report of the New York Clearing-House Association for the period from October 26, 1907, to March 28, 1908, during which the gross issue of certificates during the panic conditions was $101,060,000, collateral of the various classes of assets mentioned above was used as security for the issue of certificates, to the amount of $330,000,000 or 72.92 per cent of all securities; and yet not a dollar was lost in that whole time of crisis and danger.

In conclusion, if the loose wording of the act were interpreted as has been claimed above—and no other seems possible—the banking paper which did not come under the legal definition of "commercial paper" had to be accepted as security for notes; it had to be accorded the same treatment as any securities (other than United States bonds) held by a banking association; the amount of notes issuable on such banking paper (other than "commercial paper") was not limited to 30 per cent of the capital and surplus; and notes could be issued to the amount of 75 per cent of the market value of those securities. The valuation of the securities, whether bonds or banking paper, and the decision as to which should be accepted, finally rested with the secretary of the treasury. What a paradise for the climbing politician! Soon he became active in obtaining government deposits for banks

in his district; and he had new worlds for conquest in pressing local securities upon the magic list of the Treasury which was to give them a new value and advertisement at no cost. Certainly, we had in this Aldrich-Vreeland Act—the product of a few days struggle at the end of a session—an unexpected freedom of issues based on banking assets, as well as a Pandora's box full of unknown possibilities for evil. It was an amazing lesson on the folly of politics in banking.

CHAPTER V

GUARANTY OF BANK-DEPOSITS

§ 1. In the wake of a financial crisis are always to be found numerous proposals to give the monetary world permanent security. Already we have seen how the persistence of the idea that panics could be eliminated by issues of paper money produced legislation in 1908 of a hasty character. In the period following the panic of 1907 public attention was diverted from matters touching the issue-function to matters concerning the deposit-function of banks. Out of this discussion much was added to our thinking on banking. The essential purpose of a bank is to lend. If the loan is legitimate and the security good, the bank buys the right to receive a definite sum in the future and gives to the borrower a right to draw on demand. This immediate liability which the bank creates as the result of a loan may take either of two forms, according to the business habits of the community and the preference of the borrower: (1) the issue to the customer of the bank's own notes (or other cash); or (2) the grant to him of a deposit-account for the amount of the loan (less the bank discount). Hitherto the issue of bank-notes had received the chief attention. It is interesting, therefore, in following the slow steps of banking progress to note that the next development came in connection with the deposit-function. Such a shift of interest, even though it may have produced many fallacious schemes, pointed toward our final objective, the better organization of credit. For credit works mainly through the deposit-function. This new agitation we owe, as

also in the case of silver, largely to the activity of ambitious politicians. Although we have many serious-minded statesmen, still a measure is not infrequently judged by its power to gain votes for the party in power in the next election. Consequently, the candidate for office is eagerly searching the field for schemes which can be regarded as personal belongings, and which will appeal to uninformed masses quite independent of their true ethical or monetary quality.

Of such a character was the "rag baby" of greenback days, or the free coinage of silver of more recent memory; and the last member to be added to this motley collection is the guaranty of bank-deposits. Its appearance soon after the financial crisis of 1907 found honest supporters, not only from those who were injured by the inability to withdraw deposits in the days of the panic, but also from those who believed they had found in it a means of preventing panics. Superficial thinking as to panics, and little understanding of the actual operations of banks, have provided a soil in which the proposal for a guaranty of bank-deposits may take quick root. In the interests of a sound basis for our monetary and banking institutions, it is well worth the while to give a searching examination to a scheme which has been proposed not only for the State but also for the national banks, and which has already become law in several of our States. It cannot be regarded as a dead issue so long as it is recommended to Congress by the comptroller of the currency.[1]

§ 2. The purpose of the scheme is to distribute the losses to depositors arising from bank failures among a large number of banks, instead of allowing them to fall

[1] See *Federal Reserve Bulletin*, May, 1918, p. 429.

on the innocent depositors who were not responsible for them. To this end it is proposed to levy a tax on the bankers to create a fund which, in charge of the State, shall be used to pay off at once the claims of depositors in insolvent banks. Some advocate the guaranty of the government or State, others lay the whole burden on the banks, aided, perhaps, by an initial grant from the government. There is, however, no agreement as to the actual working of the plan: (1) some insist that its essential value lies in saving the depositor from waiting for his funds until the liquidation of the bank's assets; while (2) others think it is only to assure the depositor against ultimate loss, in case the assets are insufficient in the last resort. There is a difference between these two objects: the former provides for immediate, the latter for ultimate, redemption of deposits. Arguments for the one would not apply to the other. At first, the benefit was supposed to centre about the ability of the depositor in the failed bank to cash his claim at the very time when emergency conditions were dangerously pressing upon him. Hence, he should not be crippled by loss of his means in a time when he must meet maturing obligations. This view, however, seems to have been abandoned as untenable, because it was quickly pointed out that in the panic of 1907 deposits of more than $100,000,000 were tied up; and to pay off this sum on demand would have required an accumulated guaranty fund much larger than that mentioned by any of its advocates. The Fowler Bill evidently assumed that $25,000,000 would be enough, while elsewhere $50,000,000 was thought sufficient. On the other hand, if the fund were intended only for the ultimate redemption of depositors' claims, it would not prove of much advantage to the man in the hour of panic. The panic and the vital need

would be long gone by before the claim was realized upon.

In proposing to guaranty depositors in general there is an obvious lack of discrimination in failing to distinguish between depositors in savings-banks, whose assets must necessarily be given a long-time investment character, and depositors engaged in active business, who have checking accounts at commercial banks which must always keep assets in cash sufficient to meet normal demand requirements. For this first class savings-banks under the laws of the various States are created; but, obviously, not all States have been careful in providing safety for such depositors. These small depositors are the ones usually referred to when pictures are drawn of the misery entailed upon persons who could have had no means of deciding whether one bank was safer than another. The protection for depositors in savings-banks (or small private banks) is a wholly different problem from that for depositors in commercial banks.

It is for this first class that government postal banks were suggested as offering absolute safety. Apart from the inevitable difficulties arising from the investment of hundreds of millions of dollars by government officials, and the selection of securities—very grave difficulties—there could be no doubt as to the safety provided by the State for all depositors who would be thought incapable of intelligent choice of a bank in which to make time-deposits. Therefore, government postal banks should remove much of the sentiment manufactured for consumption among the small depositors of the country in favor of the insurance of bank-deposits. Moreover, by caring for this class of persons, who might be victimized by unprincipled bankers, the case for the guaranty of deposits in commercial banks which are left there by active and

keen business men—who, moreover, usually deposit where they can also get loans—can be better treated by itself. Nor has the establishment of a government savings system, in my judgment, had any appreciable effect on the sums left with the commercial banks.

The real question, therefore, has to do with commercial banks, such as our national banks, and some of those created by the States; for the trust companies and State banks, while carrying on savings departments, also strive actively for the business of commercial banks, and cannot by any means be ignored. Later, however, the national banks were prevented by a decision of national officials from joining any guaranty schemes. Yet, in the main, the national banks received the greatest attention in the discussion. The point was raised that because the national banks issue notes, the insurance of these notes by a guaranty fund, providing for their immediate redemption, has been generally admitted as desirable and feasible; even though their ultimate redemption must be secured by a first lien on assets or by the deposit of bonds. If, then, the insurance of the noteholder is regarded as necessary, why not extend the same idea to the depositor?

§ 3. There is, however, a wide difference between the position of the noteholder and that of the depositor. When a demand-liability of a bank, in the form of a note, comes to be used as money, and is passed from hand to hand by buyers and sellers who have no knowledge whatever of the standing of the issuing bank, it must have universal acceptability. It should be no more necessary for each receiver of the note to stop and ascertain the solvency of the issuer than it should be necessary for the receiver of a gold coin to stop to test and weigh the fineness of the metal contained in it. It is not in

the interest of the bank, but in the interest of the busy public, that protection is thrown around the issue of notes. In its work as a medium of exchange the note often goes forth to a great distance from its place of issue, and often remains in circulation for a long period before being returned for redemption. It is quite otherwise with the deposit-currency. While the note performs a general and social function, a deposit arises solely from a personal and voluntary act. Deposit-currency can never possess such a universal and general character, because each particular check must always submit to proof of the existence of funds sufficient to meet the order. The noteholder is usually an involuntary, and the depositor a voluntary, creditor of the bank. The use of a deposit always implies recourse to a bank in order to give it effect in payment; while a note requires no proof, no indorsement, no identification in establishing its right to move in the world of exchange. The depositor selects his own bank and takes the risks implied in a voluntary choice, thus becoming responsible for his act, just as any one does who gives credit to a buyer or lets a house. Consequently, the reasons for a guaranty of the notes are obvious; while they would have no application to the guaranty of deposits. If it be said that depositors are often ignorant of the soundness of one bank as compared with another, it may be answered that such an excuse might be admitted for the class of small savings-bank depositors, but not for the ordinary man of business who deals with a commercial bank. There are abundant means for finding out the standing of banks in any city. Or, if it be said that no depositor, not a director, knows what is going on on the inside of a bank, so it might be said that a seller of goods on credit does not know what the distant buyer is doing with his purchased goods, for which he has not yet paid.

§ 4. A depositor is, of course, a creditor of a bank; that is, the relation of a depositor to a bank is only one of many other relations existing between creditor and debtor. Is there anything peculiar in the case of the depositor which sets him apart from all other creditors, who have voluntarily entered into a creditor relation, and which entitles him alone to protection against the consequences of his own acts? If one sort of creditor should be insured against the usual mischances of business, why should we not insure all? Why discriminate in favor of him who is rich enough to have a bank-deposit? A humble washerwoman who often has outstanding debts which she cannot collect ought to be insured against loss as well as a depositor; she has little means of knowing, except by bitter experience, whom to trust. And the same might be said of the cobbler, the milkman, the grocer, the doctor, the merchant, or the large wholesale seller of dry-goods, or the seller of any other article; for they have accounts against others for which they need the collections as well as the depositor in a bank—perhaps more. Why this sudden access of interest in the creditors, when in the silver agitation every true patriot's heart was burning with zeal to help out the poor debtor? Has the politician exhausted the possibilities of sympathy in the debtor, and wishes to try new pastures? Certainly, the proposal to insure depositors as an application of a general principle of insuring all creditors does not seem to be practical.

Pathetic pictures have been drawn of the misery created by the failure of a private State bank in Chicago, the Milwaukee Avenue Bank: how innocent men and women lost a life's savings; how foreigners saw their fortunes disappear before they had become settled in the new land; how small dealers were ruined; how some

became insane and others committed suicide. Then, it was added, almost the whole of the deposits were in the end paid out of the assets by the receiver. Hence, if the deposits had been guaranteed and the depositors had been paid off immediately, all this misery would have been saved. No one would depreciate the frightful results of this unpardonable wrong-doing; but is this the only kind of misery to be cared for? And should the State consciously engage to care for all such cases arising from accident or fraud? Let us turn from the picture just given to another. An honest and successful dealer was selling goods to Southern buyers before the Civil War. On the breaking out of the conflict he found all his outstanding debts uncollectible; he was ruined; his children had even to be withdrawn from school and set to work for their bread; and this man, broken down, ended his life in the poorhouse. He lost everything; while, in the other case, depositors who waited recovered most of their deposits. If depositors suffer from no error of their own, so also did our merchant suffer from no error which he could have repaired. In both cases, the persons had acted voluntarily, and both had to take the chances going with acts of their own choice. When all evil and possibility of misjudgment have gone from our world, then, and only then, may we think of insuring the whole class of creditors, including the depositor.

There is no justice in laying the depositor's losses, for which he is not responsible, upon others who, also, are not responsible for the losses. The honest and efficient banks cannot in justice be asked to make up to a depositor in a failed bank losses for which the honest and efficient banks had no responsibility whatever. It would be clearly unfair to hold a small, conservatively managed country bank responsible for the "frenzied finance" of

some large bank in a great city. All reason, all justice, demand that the punishment be inflicted on the doer of the wrong and not on the innocent neighbor. In fact, the ethical justification for taxing sound banks to cover the lapses of unsound banks has no existence whatever. It is unmoral. Moreover, it is a question whether the courts should enforce such a law against the rights of property.

§ 5. More than that, it is not supported by any theory of political expediency but the socialistic. The advocates of insurance deplore the suggestion that it is socialistic, and are as much horrified by the mention of socialism as the devil is by the sight of the cross; and yet what does the analysis show? It is not necessary to explain to intelligent readers that socialism is not correctly defined by saying that it is opposed to individualism; socialists look to the State to do for them what they admit that they cannot do for themselves under a system of free competition. They charge against the forms of society what is due to the deficiencies of human nature, assuming that a change in the forms of society will change elemental human nature. The failure to hold their own in the struggle of life is the incentive to socialistic thinking. Disagreeable as it may sound, in reality socialism is the philosophy of failure. To be asked to be relieved from the ill success, or risk, of one's own business ventures is of the very essence of socialism.[1] When human nature has changed its spots, and can be trusted to go straight without existing incentives, then without expecting a depreciation of human fibre we may begin to remove the dread of loss from those who make mistakes. It is only because men must look out for

[1] See Laughlin, *Latter-Day Problems*, revised edition, chap. II.

themselves that they differ in business fibre from women and children who are separated from the world of competitive effort. One may admit all the distress arising from the inability of the depositor to draw his deposits in cash; and yet one would not, as a consequence, need to demand insurance against every emergency in which misery may arise from the hazards of business. The essential idea in the scheme for guaranteeing deposits in commercial banks—quite apart from the humble savings-bank depositor—is to relieve a man from the responsibility for using bad business judgment; and it is based on the principle of freeing men from the results of all business engagements in which there may be a risk of loss. If we once begin on this principle, we must care for all those who have entered into the relation of creditor to another. The scheme is the product of a narrow mind which has seen only one superficial phase of the problem, and which has hurried to a general conclusion without having studied the wide-reaching effects of an enervating and impractical policy.

Indeed, the origin of the guaranty idea is traceable either to the general prejudice against banks or to the attempt to make men good by law. It is purely populistic, or socialistic, in its parentage. On the one hand, it seems to be based on the belief that banks are rich and ought to bear the burdens of the unsuccessful. If some banks are badly managed, then make the whole rich banking fraternity bear the losses. Thus, by hook or by crook, no matter whether the system is just or unjust, the bankers will have to get out of it among themselves the best way they can. They can stand it better than anybody else. Let the moral question go hang. In the second place, the plan is an attempt falsely to make one banker as good as another by law, when we all know that

by nature they must differ with differences in skill and integrity. The supporters of the guaranty system are evidently appealed to by the socialistic quality in it. The unsuccessful banker may have a grudge against the successful one; and then it is easy to get favor for a law which would help them to escape the results of their own failures and to draw down to their own level those who have succeeded. In reality, there is only one royal road to large deposits: that lies through skill, integrity, good management, and time enough to enable the public to learn of the existence of these qualities.

§ 6. In some of the pleas for insurance, deposits are supposed to be "all the money people possess," "the people's cash," a "huge volume of money." Since this sum, fabulously large, is in the banks, the whole business fabric, it is assumed, must rest upon the banks. The only thing which sustains this critical situation is supposed to be the confidence of the depositors in the bank; when time of stress comes this confidence gives way to distrust, followed by a scramble for cash. Then, says the insurance advocate, do that which will establish perpetual confidence by the depositor in the bank, and we shall never more have panics. The plan is so compact, so easy, that it recalls at once the naïve method by which the Chinaman got his supply of roast pig.

Probably it has never occurred to such theorists to examine the payments to a bank by depositors in any one day. If they had, they would have found that in large cities the cash paid in was insignificant in amount compared with that paid in in checks drawn on deposit-accounts. Moreover, the deposit item in the national banks now moves in close correspondence, in amount and in changes, with the loan item. In fact, a loan is im-

mediately followed by the granting of a deposit in favor of the borrower. That is, the mass of deposits in commercial banks are largely the result of loans; and the creation of a demand-deposit following a loan is always accompanied by leaving an equivalent value, as the security for the deposit, in the assets. The loan given for carrying wheat or cotton 30 or 90 days creates a demand-deposit which can be drawn upon on demand by the borrower; but the assets constitute in effect a claim over the wheat or cotton, or its equivalent value, which will issue in some means of payment in 30 or 90 days. If the goods are salable, the deposits are safe. In short, the deposits are as safe as the assets on which they are based. Provided loans are based on commercial paper, the deposits are as safe as the quick goods passing between buyer and seller. The deposits, therefore, depend for their safety upon the kind of assets taken by a bank for a loan; they do not depend upon an abstraction like "confidence." To secure safety to the depositor, all attention should converge on the quality and liquid nature of the assets in the loan account. In order to have confidence, we must primarily see to it that loans are made with good judgment. The whole matter pivots on this consideration. The only way to avoid a crisis is to avoid expansion; which is only another way of saying, avoid taking assets which will not certainly protect the deposits when liquidation is enforced.

§ 7. When, therefore, insurance of deposits is proposed as a means of preventing panics, because it will secure confidence, we are confronted with a singularly crude understanding of the causes of panics and of what the operations of a bank really are. Confidence, of course, has its place in these matters; but we can have confidence

only if there is a basis for confidence. If freight is sent on a railway, accidents cannot be avoided by serenely leaning back and assuming—after Christian Science methods—confidence. If the railway is carelessly managed and poorly equipped, there will be wrecks and destruction of freight, no matter what the mental attitude of the shipper is. But then, says the insurance advocate, tax all the railways for an insurance fund to pay for the losses; and, then, notice how all the good railways will report upon the bad ones, with the result that there will be no more accidents. This illustration brings forth the gist of the whole question. You can prevent accidents and losses only by directing your discipline to men and equipment; you can secure safety by correct railway methods, not merely by requesting confidence. No, say the insurance advocates, establish a guaranty against all losses, and you will have confidence, no matter how badly a railway conducts its service; and, if good railways must contribute, they will see that the bad railways have no more wrecks. Imagine, in practice, the outcome if the Pennsylvania Railway were to be called upon to pay for damages due to accidents on the Erie or on the Baltimore and Ohio. The Pennsylvania, if well and safely conducted, has enough to do to watch its own road, to say nothing of a road over which it has no daily and direct control. If the poor road were free from all responsibility for damages due to its own management, what incentive would there be to improve its methods? Insuring the goods may reimburse the shipper, but it does not touch the internal conduct of the road. And, if a good road gets no advantage from its fine roadbed, its solid bridges, its well-trained force, why should it keep up its superior condition? If it does not gain traffic by its superior condition over an inferior road,

there is no reason for expenditure of mind and money in safeguards.

The parallel between the railways and the banks is practically complete. Confidence in banks can be due, not to external forces, like insurance of any losses which may occur, but to internal forces directed upon the methods of business management, and the quality of the assets which serve as the security for the deposits. If the internal management is careful and judicious, the deposits are safe, and we can have confidence in their safety. Moreover, if a good bank gets no advantage from its sound business methods, its conservative loans, its skill in avoiding losses, and its experienced staff, why should it try to keep a superior standard? The insurance idea seems to be that we can have confidence in banks, if only some one will pay the losses. This is as much as to say, we are not afraid of fire, even if incendiaries are about, because we are insured; when, in truth, the only permanent confidence is due to measures which will eliminate the incendiaries. So, in banking, everything is secondary to the character of the banking management and of the assets in the loan item.

It cannot be insisted upon too strongly that the effort to create confidence and prevent panics by insurance of deposits is taking hold of the wrong end of the problem. The deposits, as has been said, can never be any safer than the assets. Therefore, if we wish to create confidence and prevent panics, every effort should be directed to securing only the safest kind of assets. This is the crux of the whole matter. To talk only of insurance, and to minimize the importance of the quality of the assets, is only to act after the damage is done; to close the stable-door after the horse is gone. To take away responsibility for banking losses is the very thing to

lower the quality of the assets. Of course, the insurance advocate will say that insurance will bring about safer banking methods; but of that more later on.

The insurance theorists probably mean that their scheme would prevent a panic, because it would prevent a run on any bank in the system. One would be curious to know upon what analysis of credit operations a crisis could be regarded as due merely to the state of mind which leads to a run for cash. In truth a run, a lack of confidence, is a consequence, not a cause, of panic conditions. It is a consequence of doubt as to the kind of business the banks have been doing; it is a consequence—as has already been insisted upon—of the poor quality of the assets. The existence of a crisis and distrust comes from loading up with speculative ventures or assets which have lost their basis of market value. Extravagance, overconfidence, undue expansion of trade based on borrowing, prices raised to an undue height under a fictitious demand, speculation for rising prices of goods and stocks are, if wide-spread, the causes of panics. The sudden realization of this unsubstantial credit, when tested by some unexpected demand for liquidation, brings on a crisis. Every experienced man of affairs knows that the material for a financial catastrophe is collected by previous years of overtrading, and expansion of credit; and that it is only an accident whether it is this or that event which touches off the powder-magazine. The actual liquidation in the months following the panic of 1907 shows upon what mistaken calculations many of our loans were based, and how rotten much of our credit fabric was. The Heinze-Morse affairs of October, 1907, were only one set of incidents in a series of existing weaknesses, which had shown their appearance as early as the

previous March. Now, when the assets in the loan item of the banks have only a fictitious value, when they lose their liquid quality, it is childish to talk about creating "confidence" by legislation, or by such a scheme as guaranty of deposits. It would not change the previous expansion of credit. A run is merely the logical sequence of what has gone before; and the evils of the past need time to be worked out. You may put salve on the spot kicked by a mule, but the salve cannot be said to have prevented the kick.

In actual fact, if a bank has been soundly managed, if its assets are sound, a bank cannot fail, even if a run on it is started. "I have been forty years in the business," says one of the most successful bankers in this country, "and I cannot recall a single case of the failure of a sound bank that could be attributed to an unwarranted run on it by depositors. If its assets are good, it can always obtain cash, or assistance. If soundly managed, it will have reserves enough to meet any foolish run; or it could borrow on its convertible assets."

Now, we have a right to ask, in what way could a scheme, which would lay the burdens of rash banking upon sound banking, stop a panic due to causes reaching back into the past? As well say that a mustard poultice applied to a fever patient had prevented his having had any fever at all. The guaranty fund would, in fact, not check runs at all. Why? Because, even in case of a run, the guaranty fund could not be drawn upon until a bank had failed. Moreover, if there were a guaranty fund, and if runs were general, and many banks had failed, the main body of depositors could not get their cash immediately, but only after liquidation—sooner if assets were good, longer if assets were poor. Unless a fund exists large enough for immediate redemption of all

deposits of all failed banks in any serious crisis—an impossible supposition, as we have shown—then the depositor must know that some delay in drawing on the guaranty fund would be inevitable. If so, and if he is filled with a panicky desire to have his money at once, such a depositor will try to withdraw his funds just as certainly under the guaranty scheme as he would do it now. In brief, as a result of our analysis, the guaranty scheme is proved to be founded on a foolish theory of panics, and on an utter misunderstanding of the facts of trade and banking.

§ 8. If the advocates of deposit-insurance are really in earnest in wishing to mitigate the effects of an unreasoning run by depositors—after previous conditions have produced a crisis—let them carefully consider the reforms needed in our system of bank-note issues. When unfavorable developments, like the Heinze and Morse revelations, created a suspicion as to banking soundness, then suddenly psychological conditions appeared arising from alarm as to the safety of deposits. Would a guaranty of deposits have been a rational cure for this fear? Let me explain briefly the situation which makes a run dangerous. In order to serve the public, the bank gives a borrower present means of payment in return for which the bank will get repayment by waiting until a time in the future. In reality, when the bank gives him a right to draw on demand, the whole risk as to the successful issue of the transaction falls on the bank; that is, the bank virtually insures the soundness of the business transaction on which the loan was based. Quite effectively, the banks convert the value of salable goods into a means of payment, and enable a borrower, by checks on a deposit-account, to exchange the value of his goods for other

goods which he wishes to buy. Obviously, no one wishes cash, since he loses interest on it so long as it is in his possession. Hence, when affairs are normal, men do not ask for cash, and banks can easily keep the percentage required in the legal reserves. This explains why a bank may legitimately have $70,000,000 of demand-deposits, and yet perhaps keep only $18,000,000 of cash reserves. Now, under such conditions, what happens if the customers lose their heads, and all ask for cash? Of course, all could not get it; and these customers, under an unwritten law, became depositors knowing they could not get it. In spite of the superficial impression that a deposit in a bank is cash, it is not so in reality; and it could never have been so "nominated in the bond," if wanted all at once. Nor could any conceivable guaranty fund be large enough to provide the cash at once. It is an utter impossibility.

But, on the other hand, observe that the whole object intended by a guaranty of deposits could be gained by a safe and properly elastic note-issue—such as has been proposed in various currency reform bills. It would enable the immediate exchange of a deposit-liability into a note-liability, without altering the relation of reserves to demand-liabilities, and yet retain for the notes the same assets as security which previously were regarded as safe for the deposits. Not only would this plan not diminish the power of the bank to lend, but it would save its reserves of lawful money from being drawn upon, and thus even increase the ability to lend to needy borrowers. But it would do another very important thing: it would quiet the psychological conditions leading to runs, by enabling the bank to pay out its own obligations in a form of "money" which would satisfy the desire to hoard, and enable trust companies, and other institu-

tions, to be supplied with cash. If national banks, in the crisis of 1907, had been able to reduce demand-deposits by increasing demand-notes, in the same proportion, they would have been able to meet the request for pay-rolls, and for the cash needed in ordinary retail trade, without having had practically to suspend payment from the Atlantic to the Pacific. By providing notes, the banks would not have obliged business houses, as they did, because of the suspension in that crisis, to withhold their daily cash receipts and not deposit them in the banks. Moreover, if depositors could have obtained notes *pro tanto*, the newly born agitation for the guaranty of deposits would, in all probability, have never made any headway. In fact, the demand for a guaranty of deposits might have been directed into a thoughtful demand for a system of note-issues which would have effectively removed the difficulties under which depositors labor in the hours of a panic.

Still further, it should be mentioned that these new note-issues should in no respect differ in color, design, security, or wording, from notes previously issued in normal times. In a crisis, or in the critical conditions preceding one, or in any emergency of the money market, it should not be necessary to go out with a brass band to inform the public that it was quite time to get into a panic because special emergency notes were about to be issued.

In times of stress, however, the depositor's need is not the most important; for if he has a deposit he can pay a debt by a check. We must consider, in this matter, not the banks, but the great business public who need help. The fundamental need is the grant of a loan, or the continuation of an old one, which gives the right to draw on a deposit. In a panic men are driven to liqui-

date, to throw over securities to meet maturing obligations. A loan is the protection from ruin. If legitimate borrowers can get loans, the worst is over. It is needless to say that a guaranty of deposits does not in any way affect the ability of a bank to lend in a time of panic; therefore, it will have no appreciable influence in relieving the conditions brought on by a collapse of credit. The only thing that it can do, at the best, is to save the depositor from waiting for his funds during the time of liquidation; and even this purpose is now abandoned by insurance advocates as impossible. The real alarm—and the one which needs to be quieted—is that based on questions as to the value and character of the assets of the bank; and that depends upon the whole management in a time reaching back into the past.

§ 9. The plan for insurance of deposits is urged by its advocates as one which will induce more careful banking, because contributors to the fund will be more vigilant in acting as policeman over other bankers, and stop illegitimate methods in their inception. On the other hand, its opponents claim that it will reduce the best-managed to the level of the worst-managed banks, and remove all premium on skill, honesty, and ability.

Apart from fraud and stealing, what is bad banking? Clearly, it is the lending of too much to favored, or inside, parties; and the inability to know good from bad paper, and "quick" from tied-up investments. Every conceivable reward should exist to bring pressure on a banker to have courage in declining questionable loans. The moment such pressure is removed, the opportunity is enlarged for taking on assets, which, at the first real emergency, will crumble in value, and leave the depositors unsecured even after long and difficult liquidation. Therefore, to relieve the banker from the logical conse-

quences of his own mistakes, of his own weaknesses, is to take away practically the only real safeguard likely to affect human nature in a business touching the trusts of countless financial interests. The result of such a guaranty would, in my opinion, tend to put a premium on the "popular" and "obliging" banker, as against the careful and judicious banker; to spread throughout the country the influence of men who care more for bigness than for safety in their accounts; to build up credit unsupported by legitimate trade; and in the end to bring on financial convulsions proportional in disaster to the extent of the doubtful banking. Not only would it be unjust to ask the efficient to meet the losses of the inefficient, but it is poor policy to expect the inefficient to do that for which they are unfit.

An essential difference between banks in management, stability, conservatism, and success cannot wisely or justly be wiped out, without losing the very elements of safety and permanence in our business relations. A great bank with a large capital and surplus affords a wider margin of safety to deposits than can be afforded by a small bank; and the large bank will draw deposits for these very reasons. Moreover, depositors in practice keep their deposits where they are likely to be able to get loans from time to time; and an examination of figures in any commercial bank would probably show that, during any given season, some large depositors had been owing the bank about as much in the form of loans as the bank was owing the depositors. In that case, in order to treat both sides fairly, would it not be just to ask the depositors also to insure the banks against loss from loans? In fact, if the argument for insurance of deposits has any validity, then the same system, in order to treat both interests in question with equal justice, should be extended by a tax on all borrowers to insure

the bank against loss from unfortunate loans. If this were done there would be no need of guaranteeing deposits; for if assets were safe, deposits would be safe. Indeed, too much is claimed for this guaranty of deposits. All the gains of society are credited to it, until one is inclined to think its advocates see in it a remedy for all the imperfections of man.

We have previously explained that a guaranty system would promote bad banking, but the advocates go to the length of asserting that it would positively discourage reckless banking. In what manner is it thought it would discourage the making of bad loans? By proposing to watch the paper offered to banks? Not at all. What, then, is the argument for this pure theory? "Under this plan of securing the depositor," says Mr. Bryan, "the stockholder loses all that he has before any other bank loses anything. Not only does he lose all his stock, he also loses the penalty that the law fixes, and the loss of the stock and the penalty are enough to make him exercise care." Is it possible that Mr. Bryan does not know that under existing law every bank must itself first lose all its capital, surplus, undivided profits, and stockholders' liability, if it is guilty of gross mismanagement, before the depositor loses? [1] Then, from Mr. Bryan's point of view, just as things are to-day, we have all the conditions to insure vigilance just as well as if we had the much-vaunted guaranty of deposits. The only feasible guaranty system is now in actual use.

Let us further analyze the practical working of this matter. Suppose a bank accepts the theory of its advocates that the guaranty of deposits will prevent all runs; that, since the depositor is wholly protected, he will not withdraw his funds in a crisis. Obviously a plan which makes the banker think there will be no demand

[1] See Chapter VI, § 3.

for cash reserves in a panic will take away the necessity of forcing him to carry only such assets as are quickly and surely convertible into cash in an emergency. Under this scheme there will be no need of having good assets to offer to outside banks for assistance when hard pressed. Thus, from another direction we reach the conclusion that the plan will remove the safeguards against reckless banking.

Since the guaranty of deposits will not prevent the materials for a crisis gathering; since it will not advance sound banking methods; since it is unjust to legitimate bankers, and since all the benefits to be gained by it can be secured by a proper note-issue (which would mitigate runs), or by better methods of banking, there is no great reason for going into a scheme which is as distinctly socialistic as this one. Moreover, among the means within our reach for securing better banking is the improvement of national bank inspections. Appointments as inspectors have been made largely for political, and not for expert, qualifications; nor are the fees, assignments, and frequency of examinations what they should be. The clearing-house associations, in default of proper national inspections, and also to aid in legitimate banking by State banks and the trust companies clearing through their associations, established inspection agencies of their own, which have proved remarkably efficient in securing safety to the community from failures. Such action is worth all the guaranty schemes ever born in giving protection to depositors, and it is done in the only businesslike way practicable. The example set by the Clearing-House Association of Chicago, after the Walsh failure, has been followed in other cities.

§ 10. It is said that, as we have insurance for plate glass, for houses, and for life, we can rightly have insur-

ance for deposits. That is clear: we agree. In life insurance the man whose life is insured pays the premium; he never asks his neighbor, who is not insured, to pay his premium for him. So, to make the case parallel, the depositor should pay the premium. That is a business, not a political, proposal. If so, companies insuring deposits would charge a high rate for deposits in badly managed banks and a low rate in well-managed banks. That would very soon separate the sheep from the goats.

When examined from the point of view of technical insurance principles, the guaranty method is not impossible of treatment for the hazard incurred. Any uncertainty can be insured, provided the premium is large enough. It is said that companies already exist ready to insure deposits at $\frac{1}{4}$ of 1 per cent; but they evidently expect to choose the banks. And just here arises the central difficulty. In ordinary fire insurance, one enters it voluntarily; and one gets a different rate according to differences in the moral and physical hazard. Yet in the guaranty of deposits all banks irrespective of differences in management are forced to enter the scheme. If a group of banks of high standing voluntarily chose to insure each other's deposits, because they had confidence in each other's management, that would be a different thing from the plan generally proposed. Moreover, the parallel with fire insurance, in which the owners of the property at risk pay the premium, and the insurance of deposits, in which the depositor does not pay the premium, does not hold. As a strictly insurance question, it should be left to the insurance companies and the depositors. This was practically the outcome reached by the Kansas legislature, which, following the radical action of Oklahoma, established a guaranty of deposits by State law.

If the guaranty is desired for the immediate redemption

of all deposits in failed banks in any crisis, a very large fund in cash would be required. For deposits in national banks alone, a 5 per cent fund would be about $216,000,-000—a sum too large to be allowed to lie idle in cash. If invested in bonds, it can no longer be regarded as available for immediate redemption. In fact, the aim of immediate redemption, as already said, seems to have been dropped. If, on the other hand, the guaranty is intended only for ultimate redemption, after the bank's assets have been liquidated, it will not materially change existing conditions, and will not give ardent advocates of deposit-insurance what they are clamoring for—the immediate control of their funds in failed banks. Of course, it might be said that, if ultimate redemption were assured, deposit-accounts in failed banks would become negotiable, like any other delayed payments. But the same is true now: the accounts in the suspended Knickerbocker Trust Company of New York were bought and sold in 1907; and the price should properly vary with the time of discount and the risks involved. The average annual losses to depositors in national banks, after complete liquidation, have been remarkably small, or only 1/20 of 1 per cent for forty-three years. This fact has been used to prove how small the guaranty fund need be. But if ultimate redemption is accomplished with such little loss, there is not so great a need for a fund as supposed. The error of the insurance theorists is in confusing ultimate with immediate redemption, and arguing that if a small fund is needed for the former, the latter can be as easily provided for. The mistake is patent.

§ 11. Finally, the appeal to history gives the plan no authority. We have had experience with a guaranty of deposits in New York under the Safety Fund Act, of April 2, 1829. The conditions of the country and the

understanding of banking were such at that time that the lessons from that experiment cannot have very much value. There was then held only one reserve for both notes and deposits. Expansion of loans in those days meant, in the main, an expansion of notes. The safety fund was, therefore, a protection to both notes and deposits, but mainly to notes; as business, however, was then largely done by notes, its service was much as would be rendered to-day by a guaranty of deposits. What then was the outcome? The fund was established by levying a tax of ½ of 1 per cent on the capital stock, until a fund of 3 per cent was reached. After eight years the fund was tested by the crisis of 1837, when there were ninety banks in operation with a capital of $32,200,000. All the banks stopped payment, and the act itself was suspended for a year. Again, in 1840–1842, the system was put to the test by eleven serious bank failures. Thereupon, in 1842, it was decreed that the fund should hereafter be used only for the redemption of the notes of failed banks. The experience of Vermont and Michigan was still less satisfactory. In brief, as a guaranty of deposits such a fund proved a signal failure—although the experiment, as I have said, is not conclusive for present conditions.

CHAPTER VI

THE DEPOSITOR AND THE BANK

§ 1. All bankers ought to welcome the discussion caused by the proposal to guaranty deposits, because it will inevitably bring out a better understanding of the vital functions of banking and better explain the true services of banks to the community. All that bankers can desire is the truth about their business. It is undoubtedly clear that the reason for there being any question at all to discuss exists in the misunderstanding in certain quarters as to what banks really do, and as to what is essential to sound banking and the safety of depositors. There can be a wish only for a fair field and a full discussion.

The argument in favor of insuring deposits is addressed to two classes: (1) the depositors, and (2) the bankers and stockholders in banks. In this order we shall further discuss the subject.

It is said that it is the depositor who makes banking profitable. Here appears a misconception as to the banking business. In reality, deposits are only the raw materials for profits; they must be wisely and skilfully managed or there would be, not only no profits, but even losses. To have a profitable result, we need skilled labor to work up the raw materials, not only in industry, but in banking. The mere existence of capital does not insure profits; everything depends upon what is done with the capital. Capital is often badly invested and lost. In banking, we shall see that practically everything depends upon wise, honest, and capable management.

Moreover, since the days of the Bank of Venice, banks have come into existence as a means of satisfying a need of the business public. Persons deposit in banks voluntarily because they get privileges in return: sometimes interest on deposits; collection of checks deposited; a chance to get loans where deposits are kept; and, above all, to share in the most convenient, least expensive, and most generally used medium of exchange ever devised, by which payments can be made anywhere in the land through checks drawn on a private account; and all the expense of this bookkeeping is usually given free to the depositor. All the monetary services of the general government, all the issues of every kind of paper money, do not begin to compare with the service rendered to the public by the work of exchanging goods done by the banks and clearing-houses through checks drawn by depositors on their accounts. Take that away from the depositors for twenty-four hours, and the whole trade of the country would be paralyzed; and yet there are persons who say that depositors are not given anything in return by the banks.

§ 2. But the misunderstanding of commercial banking shown by the advocates of a guaranty of deposits goes still further, when they demand such a guaranty on the ground of justice to depositors: that they ought to have a place wherein they could leave money and get it again whenever they want it. Now, if a depositor wishes none of the privileges of a checking account in a commercial bank, he can put his money in a safety-vault, and get it again whenever he wants it. In a commercial bank, on the other hand, it is never pretended that if all depositors wanted their money at any given moment all could get it. Why? Because a commercial bank could

not exist if it did not invest a large part of the funds deposited with it. It creates demand-liabilities to an amount equal to all its deposits, but it tries to have paper maturing in such a continuous way that it can meet all normal demands for cash. A solvent bank can always meet cash demands if given suitable notice of what is coming. Yet the agitator, who does not seem to know the difference between a safety-vault and a commercial bank, asks for what is humanly impossible —as a matter of justice. He asks that banks should receive the deposit, but in the same breath he assumes that they should never do anything with it. Justice is assured when, and only when, the banks invest in sound assets; and all depositors can secure their funds only when the management is successful, cautious, and conservative. The deposits, in short, are as safe as the assets are good; and the sum and substance of the whole matter is to be found in the character of the management. We come back to this truth from whatever point we begin our researches.

I have said that the safety of the deposits depends upon what is done with them. A considerable part of the deposits, as is well known, are loaned out. Now, if you could force all the borrowers of a bank to insure that bank against losses from bad loans, you would give both the bank and the depositor absolute safety. But if the borrower of good credit declines to be responsible for the borrower of poor credit, you cannot blame the safe banker for refusing to be responsible for the speculative banker.

Yet it may be said that commercial banks have a quasi-public function; that depositors are innocent of the inside doings of banks; that when the banks invest deposits they put them out of reach of the de-

positor; and that too much is asked when the depositor is required to trust to the soundness of the investing judgment of bank officials. It is further added that when the authorities of a government, State, or city deposit with banks, some special security for the deposit is given; and that if a bank exacts security from the borrower, the bank should give security to the depositor. If a State or city exacts security for its deposits, it is the subject of a special contract between the depositor and the bank in which the deposit is made. If a private depositor wishes to make a similar special arrangement with a bank, he can do so. But now mark just where the guaranty advocates miss the point. They are not urging that each bank should guaranty its own depositors, but that a sound bank should guaranty depositors that it never heard of, in a bank over whose management it has never had the slightest control. That is unjust. It is near to robbery. To this case is joined the proposition that the very existence of banks organized under a national act gives a presumption to the trustful public that such banks are sound; and, if so, the government should see to it that the depositors are made absolutely safe.

§ 3. In serious fashion let us look this case squarely in the face. Apart from the great privileges given by the banks to depositors—already described—do the banks recognize the fact of their quasi-public function, and that they must give security to their own depositors for exercising good judgment in making loans, with the knowledge that the stockholders will suffer a heavy loss in case of error or fraud? The answer unequivocally is, they do. In fact, the lapse disclosed by the advocates of insurance of deposits in no part of their argument appears more obvious than in not knowing that the banks

now put up a very large fund as a security for their depositors.

There are only two possible ways of using a guaranty fund: either for (*a*) ultimate, or for (*b*) immediate redemption of deposits. Let us consider ultimate redemption first on the assumption that a guaranty of deposits should be urged on national banks. Is it conceivable that the political orators do not know that there is already a guaranty fund for the ultimate payment of deposits? The capital, surplus, and undivided profits of every national bank is the buffer between the depositor and loss. Only after the misjudgment of a bank has destroyed its capital, surplus, profits, and shareholders' liability can the depositor suffer loss. Is this effective, in fact? That it is effective is disclosed by the figures, quoted even by the guaranty advocates, that the loss to depositors in over forty years of the national bank system is only 1/26 of 1 per cent per annum. Here, then, we have final and complete proof that the banks actually do insure their depositors at the risk of great loss to themselves. On May 14, 1908, the amount of this ultimate guaranty fund was as follows, for the 6,778 national banks:

Capital	$912,361,919.59
Surplus	555,000,248.14
Undivided profits	203,108,414.78
Stockholders' liability[1]	273,000,000.00
Total	$1,943,470,582.51

[1] Although the shareholders' liability is legally equal to the capital stock held ($912,361,919.59), yet it is well known that actual collections fall short of the legal total. Shareholders may have no other attachable property than their shares. The aggregate capital of insolvent banks, finally liquidated, was $59,622,420; assessments levied, $36,246,390; collections from assessments, $17,616,404. Thus the percentage of actual collections to capital was, in round numbers, about 30 per cent. *Cf.* Table 73, *Report of the Comptroller of the Currency*, 1907. The figures for this year are typical and serve as well as those for any later years to illustrate the principle.

Omitting deposits in the national banks by the government and disbursing officers to the amount of about $180,000,000, which were covered by bonds, the private deposits amounted, at the same date, to $4,313,656,789.59. Therefore, the insurance fund for all the banks amounted to about 45 per cent of all the private deposits. This shows, of course, that when a depositor is considering the selection of an individual bank in which to deposit, he gets a larger security, other things being equal, from those having the largest capital, surplus, and undivided profits.

But, an objector may say, the banks themselves keep this fund in their own hands and invest it just as they do deposits. Of course they do; but even if there were a shrinkage of 50 per cent in the assets there would on liquidation still remain a cash fund of about $1,000,000,000, or more than twenty times as large as any sum proposed by the advocates of a guaranty fund. It is all available for the ultimate liquidation of deposits. Moreover, in Oklahoma, the State redeposited the guaranty fund with the banks.

§ 4. Next, let us consider (*b*) immediate redemption. No one has gone to such an extreme as to propose the segregation of a fund large enough for the *immediate* redemption of all deposits. In fact, the withdrawal of any large sum—even 5 per cent of deposits—from the banks to any depository, where it would remain uninvested, is purely chimerical; and, if invested in bonds, it would be of no use as a cash fund for instant use.

Immediate redemption in cash is impossible, in any serious crisis, because cash is, by the very nature of a crisis, out of reach. In the panic of 1907, the closed banks in New York alone, as has been before mentioned,

had deposits of about $100,000,000. During that panic, where in this country could that sum in cash have been obtained? And this says nothing of the closed banks at that time in the rest of the country. Even the Treasury of the United States did not have enough. In fact, it was itself in a panic and planning to get the banks to come to its aid when duties fell off.

If other than the failed banks—the latter having been badly managed—had been called upon, when the needy business public were pressing them for loans, to put up this cash out of their own resources—in addition to the demands from country banks in the interior—the panic would have spread destruction far and wide. Such a guaranty system would have aggravated every evil. That is, just when sound banks were stretching every nerve to save legitimate business concerns, they would have had their reserves reduced enormously, solely to cover the mistakes of unsound banks for whose conduct they could in no sense be held responsible.

§ 5. In view of the small loss to depositors in over forty years of the national bank system—as if that were not in itself a complete answer to their argument—the advocates of a guaranty fund showed a further misconception as to banking operations by saying: If this loss is so small, why not go further and give us absolute security?

As if anything in human affairs is capable of absolute certainty. Men are not yet perfect; and mistakes may be made in our judgments as to the outcome, not only of business, but even of political expectations. A bank does business with fallible human beings. A borrower of a bank, when in the midst of important operations, may die; or a house borrowing of a bank may have an em-

bezzling official and be crippled; or a general financial depression may unexpectedly cut off collections and oblige banks to continue loans rather than force failures—and yet, in view of all these things, the banks are asked to give absolute security. Why not ask a clergyman on becoming a pastor of a church to give absolute security that no one in his flock will ever tell a lie, commit an error in conduct, or go to hell-fire? Why not make the doctors give a guaranty that no patient shall ever die?

Banks, or any other business enterprise, cannot promise absolute security. Take the case of a steamship company. It requires cash, or security, for tickets from its passengers; yet it cannot possibly give absolute security to them. It does a transporting business dealing with uncertain elements in nature and human beings; it can only do its best in overcoming the dangers of the sea with the best obtainable seamanship and good management. The passengers on a steamer and the owners of the steamer are equally interested in not having the steamer sink. Even then, in spite of every precaution, there are losses. So it is with banks. There are inevitable risks involved in lending idle funds deposited in banks to the active men who use them in productive industry. There always will be risks, so long as men are fallible. That management is best which makes the least mistakes. If absolute security is required, commercial banks must become safety-deposit vaults. There is no other alternative.

§ 6. Thus far we have taken up the arguments in favor of guaranty of deposits addressed specifically to the depositors, as if they were at present not receiving their rights; and we have shown these arguments to be based on a misconception of banking and business operations. Now, we may next pass to the points addressed

directly to the self-interest of the bankers themselves, in order to make them favor a guaranty.

As is well known, the scheme to insure deposits requires all banks, good and bad, jointly to contribute to a fund to pay off depositors in failed institutions. The more successful the bank, the larger its deposits, the more it must pay into the fund; the less successful a bank is in impressing the public with its security and the smaller its deposits, the less it pays into the fund. The successful are to pay for the mismanagement of the unsuccessful. Let us illustrate. If burglar A robs B's house, go to the most honest man in the village, C, and rob him to pay for B's loss—it will increase the eagerness of all men to be honest and discourage burglary! C, the successful man, will enjoy paying for B's carelessness in keeping no locks on his house; and if C has to pay for all the deviltry in the town it will stimulate others to get honest so that they can pay for similar losses. As C, who had nothing to do with the case, is penalized, and not A, the burglar, the plan will discourage burglary. The scheme is perfect; it might work perfectly—in an insane asylum. Mr. Bryan has well said, and we must all agree with him: "One of the things I want to see adopted in the form of regulation [of banks] in the near future is the law that will put the penalty on the right man and not on the community." If the English language conveys its meaning clearly, those words mean that he favors penalizing the man who cheated his depositor by bad loans and not the man who protected his depositor by safe loans. If that is the case, it is only logical to suppose that Mr. Bryan was radically opposed to the guaranty of deposits.

But, say the guaranty theorists, depositors really suffer from bank failures; and the only way to prevent this

suffering is to make such a combination of all banks as will force the good banks to watch the bad banks, knowing that the good banks must pay the losses unless they prevent failures. A combination of this kind is not, of course, founded on equality and co-operation. It is a plan by which the depositor, in case he makes a mistake in choosing his bank, will have an innocent bank pull the chestnuts out of the fire for him. Of course the sound, well-managed bank would never draw on the fund; it is put up solely for the weak ones.

Let us for a moment analyze the theory that the guaranty of deposits would oblige the sound banks to watch the unsound ones, and thus cause better banking. Is it possible for good banks to prevent other banks from making bad loans? The fact that a bank is doing questionable banking is known only after loans are made. Then, how can you prevent the initial act? Obviously, only by establishing a central organization of the best bankers who should pass on every application for credit before it is given by other and smaller banks. But that is impossible, visionary. Such a remedy would be regarded by the smaller bankers as worse than the disease. It would be like creating a trust, or a "money octopus." In providing what is an impossible remedy for depositors in time of failure, it would amount to creating a means which would really destroy existing credit facilities. If mice trouble the housekeeper, you would not, in the hope of killing the mice, import a tiger that would devour the very housekeeper herself.

In truth, the only way to control the initial act of each bank when making a loan is by increasing in every possible way the rewards to sound and conservative banking. It cannot be done by saying that, if bad loans are made, the penalty for them shall fall, not on the unwise

banker who made them, but on the innocent and wise bankers who had nothing whatever to do with the bad loans. That is dangerous political, as well as banking, morals. If good management is made to pay for the evils of bad management, there will be taken away the rewards for sound banking and all reason for the growth of skill and integrity. To suggest that sound banks should pay the customers of unsound banks in cases of failure puts the responsibility and penalty on the wrong persons, and violates every principle of justice and fairness between men.

Every banker knows that a bank permanently gains deposits only by impressing the business public with a belief in its influential connections, in its foresight in meeting financial emergencies, and in its wise and skilful management. The depositor is properly influenced by these considerations. But under a scheme of guaranteeing deposits, what would be the effect?

Bankers of doubtful judgment and integrity would find themselves relying on the guaranty fund (supplied mainly by other banks) as a means of attracting deposits, instead of trying to attract them by the exercise of skilful management. As a result, the deposits of the country would be changed from a method of distribution based as now on relative estimates of wise management, to another and artificial method in which soundness of management would play no part. Under this false system deposits would inevitably be got by those who are less skilled and honest than those who now hold them. That is exactly what the plan is contrived to do. The fundamental mischief in the scheme is that it is based on the theory that all men in the banking business are equally honest and efficient. A theory based on such an error can never be supported by any but specious arguments.

The appeal is sometimes made to small banks that a compulsory insurance fund including all banks, large and small, will put the small on the same level as the large banks, so far as accumulating deposits is concerned. In brief, it is an appeal to select a bank, not on the strength of its management, but on the fact that bad management will be paid for by "the other fellow." That is, banks willing to accept this appeal are by that very fact to be distrusted; for they are soliciting business on the theory that they are to be trusted not because of their sound banking, but because of a system under which they can escape due responsibility for losses. Bankers who would advertise an insurance fund to attract deposits obviously advertise the fact that they do not expect to receive deposits primarily on their record as careful bankers.

The guaranty theorists even insist that successful banks now oppose an insurance law, because they wish to take advantage of the insecurity of badly managed banks, and to draw deposits away from them. Of course they do. Why not? Should not an honest man glory in his honesty and deserve the rewards which the community deal out to honesty? Does not an honest and upright lawyer win a larger practice over an incompetent shyster for exactly those reasons?

§ 7. As an example of what has just been explained, we have the Oklahoma experiment. Some of the banks of this State sent out cards showing the increase of their deposits. Two causes were supposed to be at work: (1) the cessation of hoarding, and (2) the relatively superior safety of Oklahoma banks, as contrasted with those having no insurance deposits. As regards the first cause (1), there was no evidence whatever but general opinion regarding the amount of money hoarded and the amount

that came out of hoards. The very word "hoarding" implies secrecy and the absence of knowledge about sums or places. But the rapid movement of men and capital to the exceptional resources of an undeveloped region was in itself enough to account for increasing deposits.

As regards the second cause (2), doubtless some minds were influenced by the existence of a guaranty. One speaker exulted over the case of an Illinois man who withdrew $6,000 from an Illinois bank and deposited it in one in Oklahoma in order to be more safe. Under any system, however, there are good and bad banks. No doubt there were some banks in Illinois to be distrusted; and the sound Illinois banks would not wish to be held responsible for them. And the same was true, of course, of Oklahoma. If a guaranty system will prevent bank failures, why is it that already in Oklahoma failures have taken place? Of course there is nothing whatever in the claim, so sensationally put forth, that a guaranty of deposits will prevent failures. There will be good and bad banking in Oklahoma under a guaranty system. If it were not certain that there would be bad banking there, then why was the act passed? Solely to make the good pay for the bad. No legislation will make every banker in Oklahoma, or anywhere else, honest and skilful. Some are certain to be weak and inefficient under any system. The whole question is: Who shall pay for their mistakes? Obviously, we all agree with Mr. Bryan in insisting that the penalty shall be put "on the right man and not on the community." The "right man" is clearly not the man who has won success in gathering deposits by the exercise of honor and discretion in his business. And no amount of special pleading can induce us to put the penalty on him. But the guaranty of deposits is,

by its very nature, intended to put the penalty on him. And, finally, the attorney-general has ruled that national banks cannot go into the business of insuring other bankers, since it is a business foreign to their banking charters. Consequently a ruling in accordance with that opinion has been made by the comptroller of the currency.[1] It is for the depositor, not the bank, to seek an insurance company chartered to take such risks.

§ 8. Not having any substantial basis in knowledge of proper banking operations, the guaranty scheme has been ingeniously urged upon bankers because of the peculiar relations of national banks to State banks. Of course a federal law would not cover the action of State banks, and *vice versa*. Now it is proposed to urge the federal guaranty law on the ground that, in any one State, such as Oklahoma, Kansas, or Nebraska, a State guaranty law would force the national banks to come in or lose their deposits. Hence, the only way to protect the national banking system against the encroachments of one or several States is to pass a federal law for a guaranty of all national bank depositors.

(1) Suppose a national guaranty law were passed. Then, on the theory of its advocates, the deposits would leave the banks in all States having no guaranty law and go to the national banks. In that case, the law would work an injury to every honest State bank. Obviously, then, the State bankers ought to be opposed to the scheme, so far as their interests are affected. But, say the guaranty theorists, in that case every State would be obliged to pass a guaranty law also. If that fol-

[1] For further information on the Oklahoma and other experiments, see Thornton Cooke, *Quarterly Journal of Economics*, November, 1909, and February, 1910; and *The Guarantee of Bank Deposits*, by T. Bruce Robb, soon to be published (1920).

lowed, of course the State and national banks would stand relatively to each other just where they do now; and there would be no gain to any bank in either class. The result would be nil, except that good banks, both State and national, would now have to carry the losses of bad banks.

But (2) suppose some States, like Oklahoma, Texas, Kansas, and Nebraska adopted a guaranty system. Then other States, having a more just view of their duty to careful banking, might not adopt it. As a consequence we should have as endless a confusion as exists now, for instance, between State bankruptcy laws. Hence, are clear-headed business men in other States, with their eyes open, likely to urge a law certain to create a confusion in business relations with correspondents in different States compared with which present conditions would be like paradise? I think not.

In order to force bankers to accept a guaranty law, however, a threat had been made that, if they did not, they must expect a postal savings law. Here the argument was addressed to the fear of losing deposits. Those who thought this threat formidable obviously failed to distinguish between a savings-bank and a commercial bank. The adoption of a postal savings law affected, in the main, only the uninformed small depositors who hoard, or who distrust the local savings-bank. In the nature of things such a system could not attract the large mass of deposits left with the commercial banks by active business men, for one overwhelming reason. A true commercial bank exercises both the functions of deposit and discount—the issue-function not being essential. Now, if a depositor is in trade, or if he is one who may need loans, he is by that fact estopped from keeping his funds with a government postal agency, from which he cannot

borrow on short time. Exactly because the government is not a bank, and ought not to be, it will not receive the checking accounts which are generally left with banks on the understanding that credit will be given when needed.

Therefore, when a guaranty advocate rises to a rhetorical climax by threatening the banks not only with the loss of small savings-accounts—which are not profitable to a bank, anyway—but also the probable extension of the savings-deposit limit from a beginning at $500 to a higher limit, which would include the checking accounts of merchants, he is not likely to carry conviction.

§ 9. Finally, the worst monetary fallacy in the arguments of the guaranty theorists is involved in the claim that, if established, the system would draw so much money into the banks as to remove all necessity for creating an emergency note circulation. The error here is in confusing property, or goods, with the medium of exchange by which the goods are exchanged. No matter how much actual coin is hoarded, no matter the cause which brings it out into bank reserves—the actual deposits then require only the usual proportion of reserves; and when the banks reach that proportion, extra coin is disposed of just as quickly as a farmer sells his surplus wheat. After that, banking goes on just as before the arrival of the hoard. But what next? If a panic appears next, there would be, as a consequence, just the same demand—be it more or less—for an elastic emergency circulation after the establishment of a guaranty system as there would have been before. An emergency in business conditions due to an overexpansion of credit will come and go for reasons entirely dissociated with the insurance of deposits—that is, if we may suppose that

human nature as it now acts remains the same after such a system is put into operation. In fact, the idea that the quantity of money in existence is of chief importance, as distinct from the quantity of salable goods on which loans and deposits are based, is but the old greenback fallacy in a new disguise. It overlooks the clear truth that as salable goods increase there is increased the basis for legitimate loans by banks; that these loans result in deposits on which checks are drawn; and that thus the banks are constantly affording a deposit-currency to the public as an elastic medium of exchange. Let those who think an elastic and enlarging currency is desirable begin to be grateful to the marvellous service rendered by the deposit-currency of the banks in exchanging over $250,000,000,000 of goods every year. Greenbacks, and even bank-notes, are far behind in this comparison of work done by our different media of exchange.

CHAPTER VII

BANK-NOTES AND LENDING POWER[1]

§ 1. In the panic of 1907 it was impressed on the public and on Congress that our monetary system was not of the kind that could successfully withstand the stress of a monetary stringency or the greater dangers of a serious financial collapse. These impressions led to a wide-spread demand for monetary reform, to the appointment by Congress of the National Monetary Commission (1908), and to the publication by this commission of a great mass of material on money and banking. These volumes may have helped in the education of Congress, but because of their bulk they were not likely to help very much in the education of the public. It is clear, however, from these volumes and from knowledge previously in our possession that the lessons to be had from other countries as well as from our own must inevitably be drawn upon in framing concrete proposals to Congress. Moreover, under our political methods, it was not a question as to what outside experts might propose, but what the leaders in Congress thought could be passed through both Houses under the existing conditions of public opinion (educated, of course, as far as possible). This situation we have had to keep in mind in all our discussions. The lessons to be got out of these volumes and the inferences from them applicable to conditions in the United States could without doubt be very simply

[1] This chapter may have some interest due to the fact that it was written in November, 1910, at the time when the plans for the Federal Reserve Act had not yet been framed.

presented. If so, and if made intelligible to the general public, there was a good chance that they could be impressed upon Congress and enacted into law.

Of course we have to beware of the man with a cut-and-dried system, who has a beautiful theory sure to prevent all panics and to cure all the ills of industry. As in the case of any disease, we must first find out accurately what is wrong, and next try to discover a remedy to meet the particular ill. First, then, as to the difficulties disclosed in the past which must be overcome by a correction of our monetary system. At that time (1910) Secretary MacVeagh by his urgent suggestions to the national banks to organize currency associations under the Aldrich-Vreeland Act of March 30, 1908, in order to be prepared for an expansion of bank-notes in case of an unexpected emergency, consciously or unconsciously indicated his belief that monetary and credit emergencies could be met by the issue of bank-notes. On the other hand, if his words were correctly reported, the chairman of the National Monetary Commission expressed the belief that the problem was not so much one of circulation as it was one of the organization of credit. The problem seems to shift between bank-notes on the one hand, and the power of a bank to lend on the other; (1) the needs of the public for currency and (2) the needs of a bank when under pressure in meeting demands for loans.

§ 2. The needs of the public for currency to act as a medium of exchange in buying and selling goods, in paying wage-rolls, in travel, etc., are obvious. In certain sorts of transactions, mainly in retail trade and in districts unused to banking methods, some form of money must be passed from buyer to seller. In total amounts,

however, these transactions are insignificant in comparison with those on a large scale which are carried on by checks, drafts, or bills of exchange—without the use of any forms of ordinary money. With an increasing population, but chiefly with the increasing products bought and sold at retail, the demand for currency, such as it is, must increase absolutely in greater or less sums. For such needs an elastic bank-note circulation, slowly rising but expanding and contracting sharply with seasonal demands, is imperative. Our old national bank circulation did not provide for this elasticity. It expanded and contracted without any direct relation to the demands of the community. To this point of elasticity much emphasis has been directed, and its importance should not be minimized; but it is to be doubted if it is as vital as some suppose. If we used only bank-notes (or other paper money) as a medium of exchange the insistence upon an elastic bank-note circulation would be of first importance; and even in the limited field in which actual money is imperative, the need of an elastic bank-note issue to the general public remains highly important. But since we have as a medium of exchange a deposit-currency which is perfectly elastic, elasticity of note-issues should receive attention only in the proportion of the importance of bank-notes to other media of exchange, under normal conditions of business.

Still keeping in mind, however, the needs of the public for a medium of exchange and not the needs of the bank itself, it may possibly appear to many that the demand of the public for expanding issues of currency is of vital importance in a time of financial distress, such as was that in the autumn of 1907. To those who set most store by the virtues of an elastic bank-note issue this

seems the crux of the whole matter. It is supposed that in a time of stringency the public will demand more circulation; and to support this view the events of the panic of 1907 have been drawn upon as proof. It is true, of course, that greenbacks, silver certificates, or bank-notes could not be had in most cities during the height of the panic in 1907, even in small sums; and as a consequence the clearing-house associations issued clearing-house notes (as distinct from clearing-house loan certificates) for circulation among the public. Without doubt, this inability to get cash for a small check on a bank or at a paying office made a deeper impression on the minds of the people than any other event during the panic. It was the belief in the need of more money, based on this experience, to which Congress evidently catered when it passed the Aldrich-Vreeland Act, as a provisional measure before a coming election in 1908. It was, as every one must admit, a striking commentary on the inadequacy of our banking and monetary system that it was impossible for the banks to supply to employers of labor and for the small needs of every day a relatively small amount of currency having a general circulation. Yet, on the other hand, it is a fact that the total amounts of the clearing-house notes issued for the use of the public were not large, nor were they long outstanding. Moreover, as affecting the ability of the producing and trading houses to weather the stress of the panic, they had practically no influence whatever. The banks were more frightened than the public. The demands of the small local banks for additional precautionary reserves drew down the cash reserves of city banks more than did the demands of business men. This was the reason for the scarcity of circulation. The holding on to their cash by city banks was primarily in the interest of reserves, and

therefore in the interest of those who might possibly wish loans or who had to be carried for a time.

The power to expand their note-issues (which are liabilities) could not have added directly to the cash reserves of the banks and thus have enlarged their power to aid needy borrowers. It is true, however, that an expansion of note-issues would have aided the banks indirectly; it would have allowed them to satisfy the urgent demand of the public for a medium of exchange by passing out their notes and thus would have enabled them to retain lawful money which could be used as reserves to support their loans and deposits. But, primarily, the issue of bank-notes is for circulation in the hands of the public and not for any serious advantage which they render in increasing the power of the bank to lend and to stave off a panic. Accordingly, the prevailing idea that we must provide against future panics and avoid a repetition of what happened in the panic of 1907 by arranging for the rapid issue of bank-notes in a time of emergency is quite aside from the real point; for it is based on the wrong assumption that it is the lack of currency in the hands of the public, and not the difficulty of the banks in lending, which is the critical thing at such a time.

This popular insistence on the view that we can prevent the occurrence of panics and meet all the dangers of a financial panic once it is upon us by the device of an expansion of bank-notes is, in my judgment, based on an erroneous analysis of banking operations in times of pressure. Very respectable authorities have asserted that our monetary system is radically at fault so long as it will not prevent the occurrence of panics. And the belief that the Bank of England or the Bank of France —as central institutions—have been able to head off

speculation and avert the evils of expanded credit have been referred to as instances of what could be done by a central institution in this country. We have been led to think that the issue of notes was the means by which the dangers of the crisis were met and its inconveniences reduced; in the case of England by the suspension of the Bank Act bringing out more notes from the issue department; and in the case of France directly by the increase of notes of the Bank of France. As we shall see later this appeal to the banks of England and France is wholly unfounded in fact.

The reserve city bank which can quickly increase its own notes can supply the demands made upon it by country national banks and correspondents—provided the country bank wishes currency only for circulation in its neighborhood and not for its own reserves. Here, again, the new bank-issues do not give the pivotal aid which some suppose always comes from additional circulation. Not being lawful money, they could not be used in reserves and therefore would not—and could not—improve the lending power of the local country bank. They would, however, as we have seen, supply currency to the country bank which could be paid out, if urgently demanded, and thus indirectly protect reserves.

Another advantage in emergency bank-notes, of course, is the use that can be made of them by national banks having relations with State banks and trust companies. By issuing their own notes they may exchange them for lawful money held by banks outside the national system. In this way they can indirectly increase their lawful money and consequently their power to lend.

All the above advantages are patent and are arguments in favor of a margin of elastic note-issues. But such issues have only a limited importance and would

not cure the fundamental difficulties existing in times of panic. The principal reason for this statement exists in the fact that, obviously, the bank cannot replenish its reserves—which are an asset—by an addition to its own notes, which are a liability. Apart from its illegality it is a banking lie.

Moreover, the use of its cash resources in the direct purchase of any kind of bonds or securities to be deposited for the protection of its emergency notes would not only not improve but really reduce the power of a bank to lend and thus reduce its ability to aid needy borrowers. A sum of $100,000 in lawful money in the reserves would support loans and consequent checking accounts of from $400,000 to $600,000 when borrowers are calling for help—provided borrowers used checks as a means of payment. Therefore, a bank would cripple itself should it invest $100,000 of lawful money in securities in order to issue only $100,000 of note-issues—thus allowing loans of only the same amount—provided borrowers used notes as a means of payment. Consequently, no system of note-issues based on the purchase of securities by lawful money would touch the centre of the need.

Finally, too much is made of the need of an elastic bank circulation in a time of panic in view of the fact that we already have a perfectly elastic medium of exchange in our deposit-currency, especially for all large transactions. The term "money" is loosely used. We use gold as a standard, but we do not use it to any appreciable extent as a medium of exchange. More than 95 per cent of our large transactions are performed by a check and deposit currency which rises and falls exactly in proportion to the exchanges of goods which call forth loans and bank-deposits. Under existing familiar methods

of payment by checks and drafts, the borrower who is able to get a loan in a time of stress has no difficulty whatever in meeting his maturing obligation by a check on a solvent bank. To get the loan is the important thing—not the particular form of liability which the bank gives him on making the discount. In fact, on getting the loan the borrowing merchant would not wish to take out notes and then be obliged to find a place in which to deposit them again. It is clear, therefore, that the mere power to issue bank-notes in itself is not the only nor the most important way of meeting an emergency brought on by a disturbance of credit.

It is a crude thought that an increase of bank-notes is needed by the general public as a medium of exchange on the theory that business men are unable to exchange goods because of a scarcity of currency. The real difficulty in a time of stress resides not with the general public and the media of exchange—for checks are as good as ever as a medium of exchange if there are deposit-accounts on which they can be drawn—but with the banks, with the power of the banks to expand their loans. This is the pivotal thing in any plan to relieve the distress of a financial panic (in spite of those who are urging an elastic currency as a cure-all).

§ 3. So much for the relation of bank-issues to the situation created by a financial crisis; but as has been already pointed out there are other elements in the situation of far greater importance. When we look back to the panic of 1907 we find three important happenings, connected in purpose and need, which altogether transcend the minor question of the issue of bank-notes, or of clearing-house-currency for public use. These three points of central importance have to do with the lend-

ing power of the banks and are as follows: (1) The importation of gold; (2) the deposit of lawful money with the banks by the Treasury; (3) the issue of clearing-house loan certificates.

Every banker, every borrower, who was concerned with the work of preventing disaster from spreading in 1907 knows how dominating were these three matters. Why? Because they directly touched the power of the banks to lend. There was a crisis, not because of a scarcity of a medium of exchange in the hands of the public, but because the city banks had had excessive demands made upon them for loans and because they held some paper which had become more or less unsound. A crisis comes because credit has been unduly expanded in a period of prolonged prosperity; because in an optimistic spirit men have entered into transactions beyond their actual means, as is shown when the test of actual payment is exacted; and in a time of fright collateral as well as goods fall in price. In such a situation liquidation needs time if disaster is to be prevented. The banks are even called upon to carry houses who have been doing a legitimate business but who are now in trouble. Just when timid persons or country banks are drawing down cash reserves, the banks are forced by the situation to increase their loans. In the one week ending November 2, 1907, the reserves of the New York banks fell $37,000,000, while loans were increased $60,000,000. Such action showed that the New York banks met a difficult situation with courage and good judgment. At their own risk they came to the rescue of a hard-pressed business public. Everything centred in those things which would aid the lending power of the banks. It is needless to say that the issue by the bank of its own liabilities in the form of notes would have been an insignificant palliative and

would not have touched (except as before mentioned) the cash reserves and the power to lend. *The one central thing to be done at the moment was to increase reserves.* Here is the crux of the whole matter, whether it is a time of an impending stringency or the storm-centre of a crushing panic. The bank's own notes (its own liability) cannot legally or morally be used to fill up its reserves (the bank's active asset). Here is the fatal deficiency of bank-note issues as a means of curing a panic. The one thing needed was lawful money which could be used as reserves. We must face facts and not be led away by theories. The New York banks got this lawful money in two ways: (1) by importing gold and (2) by deposits from the Treasury.

They imported gold as a means of enabling them to aid needy borrowers. They used their resources to buy or borrow over $100,000,000 of gold because it was one of the forms of lawful money by which reserves could be filled up. By any one who had the means of purchase, gold could be got in a week from Europe. Therefore, gold proved to be the one part of our monetary system —besides checks on deposits—which was perfectly elastic. It could be increased by importation or decreased by exportation at will.

Gold, however, was not the only form of lawful money. When banks were being drained of their reserves, the main recourse was to the Treasury of the United States. (2) Unlike bank-notes, government deposits of lawful money directly increased the reserves and increased the lending power of the banks from four to six times the deposits. The secretary, in leaving the largest sums in banks in New York, the centre of the disturbance, gave his aid where it would do the most good. It is obvious that the service rendered by the importation of gold and the

deposits of lawful money by the Treasury could not have been accomplished by issues of bank-notes.

The most important of the devices resorted to in 1907, however, as well as in former panics as far back as 1861, was the issue of clearing-house loan certificates. (3) What was the point of their issue? It was not that the country needed more money for general circulation or more media of exchange, but that the banks whose reserves had declined needed aid for the purpose of lending to hard-pressed borrowers. In a crisis what is wanted—and wanted above all other things—is the loan. Once given the loan, the borrower has no difficulty in finding a medium of exchange, by which he can transfer his credit in a way to meet his maturing obligation. The loan is the primary thing. All that the creditor demands is a means of payment acceptable in his community. It is just at this point that I venture to say we find the most confusion of thinking and the greatest amount of loose talking. It is carelessly assumed that the great need is an issue of bank-notes, when in reality the great need is some means—whatever it may be—which will enable a bank to make loans to a client, who can thereby be saved from failure and from hasty and ruinous liquidation. The whole object of clearing-house loan certificates, then, is—not to provide currency—but to make loans possible to legitimate though needy borrowers. After loans are made, checks provide all the means of payment any one needs. The increase of a bank's liabilities does not increase its reserves or its power to lend; so that the issue of bank-notes—except as above indicated—is wholly aside from the point.

§ 4. One result of the publications of the National Monetary Commission is that we ought to know much

more than before about the experience of the great banks in Europe.[1] But deductions from Europe, as has been pointed out by the chairman of the commission, must be made with caution. In England conditions as to payments by deposit-currency are much like our own; but in France very little work is done by checks drawn on deposits and nearly all by the notes of the Bank of France; and much the same is true of Germany. Thus while the general principles of banking would work out similarly in England, France, Germany, and the United States, the instruments through which they operate would be very different.

In England, in a crisis, aid seems on the face of things to have been rendered by an increase of the Bank of England notes, when the Bank Act of 1844 was suspended. In fact, as every one knows, the act previous to 1914 had not been suspended since 1866; and even when suspended, very little use of the new notes was made. Why? Although under the same management, the issue department is as much separated from the banking department as if they were different institutions. The gold and securities behind the notes in the issue department are entirely separated from the resources of the banking department. Therefore, the latter can use the notes of the issue department in its reserves. The whole point of the suspension of the Bank Act lies, then, in the fact that the banking department can fill up its reserves by taking securities to the issue department and getting notes for them under a temporary suspension of the law. The immediate object is to increase banking

[1] In all there are no less than ten volumes on European banks issued by the National Monetary Commission, amounting to 4,096 octavo pages (of which that on the German Bank Inquiry of 1908 alone contains 1,162 pages), to say nothing of other subjects treated. For students these works are highly useful and convenient.

reserves so that loans can be made freely; while the idea of getting out more notes into general circulation, on any theory that the public needs more money, is not at all considered. The mere possibility of a resort to suspension is sufficient to quiet alarm because legitimate borrowers know they can get loans whenever required, and therefore practically little or no use is ever made of the new notes. Of late years the change in the rate of discount has been sufficient to prevent reserves from falling to a point where suspension was ever necessary. Here again in an emergency it is a question of the lending power of the bank and not the need by the public for more bank-notes as a medium of exchange.

In France things are otherwise. An increase of loans by thé Bank of France is necessarily carried through by an issue of more notes. Within the outside limit set by law the bank can increase its issues at will. The essential thing, of course, is the ability to get a loan in an emergency; and when that is obtained, as a matter of course the bank supplies the special form of liability which the business public demands—which in France is not a deposit-account but a note-issue. Either would serve the same purpose as a means of payment; but that one is taken which custom prescribes—the check in England, the note in France. The fundamental thing is to be found in the power to lend and not in the note-issues. And back of that, it is the phenomenally high character of the short-time paper which allows the Bank of France quickly to adjust itself to changed conditions, together with the policy of keeping very high metallic reserves behind the notes—perhaps 85 per cent in normal times. They have escaped panics in France by greater care than is given here in selecting only high-class paper at the central bank. Copper speculation, however, can bring

disaster to a bank there as well as here. In general, the Bank of France has been able to maintain a low and uniform rate of discount chiefly because it is not a money-making machine and is excessively conservative in the kind of paper it discounts.

§ 5. Working directly from the facts of our own experience and from a reading of the volumes of the National Monetary Commission, we may be permitted a very brief statement of the constructive measures which should be undertaken to prevent the excessive and ruinous results of credit expansions in the future.

First of all, emphasis must be placed on the indisputable truth that no monetary legislation can prevent business optimism, overtrading, and the recurrent waves of speculation and liquidation. The control of such movements, which are sure to be pressed upon banks by an eager, money-making public, lies primarily in the hands of the banks. The banks are the servants of their constituencies; as a rule, they do not lead, but are apt to follow the demand of their customers; but they must not be willing to follow recklessly. Not infrequently we hear it said that European countries, with large central banks, have a system which prevents panics. The truth is that panics have been largely avoided in the last decades in such countries as England, France, and Germany because the management has been cautious and conservative in granting loans. Quite irrespective of the differences between the forms of banking organization in the United States and the forms employed in England, France, and Germany, we could as effectively suppress potential panics as they if we were as willing as they to scrutinize loans.

In the second place, we must in no way relax our efforts

to satisfy the great need of an elastic bank circulation. We need what might be called marginal elasticity—a change of relatively small amounts on the margins of a fairly large normal circulation, dependent for its amount wholly on the demands of trade and not on the fiscal needs of the government. The various bills presented to Congress—chief among which was the bill of the American Bankers' Association[1]—bear on this general point. They were important; but as previously explained they did not provide a remedy for the situation existing in a time of panic. Expansion of credit can go on, and has gone on, through the banking department of the Bank of England without the issue of any notes and solely through the creation of deposit-accounts as the consequence of expanded loans. Therefore, we must admit the fact that an elastic bank-note circulation, while bringing needed reforms, will not accomplish in times of stress what most persons have in mind when urging a change in our monetary system.

Having now disclosed the real need, how can that need be met effectively? In the main, assistance must come in such a way that reserves can be enlarged with safety. Therefore, the emergency issues—if any are allowed—must be in some form of lawful money. How and by whom are they to be issued?

Certainly not by the government. The very first lesson of public finance is to learn to separate the fiscal from the monetary functions of the Treasury. The State must separate its income and expenditures, its borrowings and payments, its fiscal duties, wholly and radically from its control over the monetary standard and the media of exchange. To confuse or to mix these is to invite disaster at the first real crisis. Compare the chaos into

[1] See Appendix I.

which we fell when we confused these two things on and after February, 1862 (on making the first issue of greenbacks as a loan), with the stability of the French standard during the enormous expansion of loans in their crisis of 1870–1873.

In brief, what is the essence of the remedy? Clearly enough, the lending power of a bank cannot be increased in an emergency by means of an increase in liabilities. It can come only by an operation dealing with its assets and in such a way that a part of the assets—either bankable short-time paper or securities—can be transformed into means of payment which will enlarge the reserves. The whole emphasis should be put upon the matter of lending power. In the past this end has, in fact, been accomplished either by using securities to import gold, or to obtain government deposits, or by getting clearing-house certificates to the amount of 75 per cent of the value of chosen commercial assets. Such methods are irregular, voluntary, and clumsy. The underlying principles, however, should be incorporated into practicable, simple, legal means open to all, and well understood before any emergency arises.

The issue of clearing-house loan certificates has been, in my judgment, a means of averting untold disaster in many crises; the collateral behind them has been based on the fundamental business of the country, and they have always been retired at an early date without the loss of a dollar. Yet it is clear that as a practical device they are somewhat clumsy and possibly exposed to the 10 per cent tax on State-bank issues. They may be, however, only the first step in an evolution to something even more effective but built up on the same lines. It is always wise to allow the remedy to grow out of our past experience rather than to introduce an entirely new

scheme to which it may take a long time to get adjusted.

Therefore, the central point of our banking reform, so far as I am able to suggest anything practical, is an organization of national banks, supervised by the government but not under government management, which shall have the power, under regulations securing great care in the selection of collateral, to transform picked assets and securities into a means of payment which can be used to increase reserves. If notes are also issued there should be proper elasticity. Such a method, after all, is essentially the same as that used in a crisis at the Bank of England—the country whose conditions are most nearly like our own. If we accept these principles and the general purpose, it would not be difficult to draft the law which should contain them.

We ought not to be wedded to names or preconceptions. It is immaterial whether such an organization is called a central bank or not. It is material, however, that it should accomplish the purpose of enabling any individual bank to meet a temporary paroxysm of credit by getting more reserves and by increasing its lending power through the deposit of first-class collateral. My instinct is against any one large, centralized institution the management of which might become an object of attack or a political prize in a campaign. So far as I can now see, it ought to be built up out of the present clearing-house organizations. There should be common action and conference of those who know the conditions of business in all parts of the country; but the actual judgment, when the quality of the paper and securities offered by a bank in order to obtain those means of payment is to be passed upon, should obviously be given only by those in certain parts of the country who are familiar with persons and trade

in the localities where the requests are made. Moreover, the relation of State banks and trust companies to the national banks in the large cities in a time of crisis can be best regulated through organizations like the clearing-house boards. There should be no difficulty whatever in creating local or district clearing-house boards,[1] chosen by the banks themselves—just as clearing-house committees are now chosen—who should pass upon the issues of those Reserve notes. These district boards might then be united or represented for common action in a central board,[2] who might have a veto upon the extreme action or the possible unwisdom of any one local board. The scheme has, moreover, the political advantage that it does not propose a money-making institution nor a financial "octopus," but a simple, direct method of enabling the borrowing public to get aid from banks in time of distress.

Were such an organization once put into operation I am firmly convinced that we should henceforth be preserved from the highly terrifying and unnecessary paroxysms of credit which have characterized our past financial history. More than that, we should then come to understand by actual experience—just as in England since 1844—that our expansions of credit and its liquidation may come and go independently of the quantity of bank-notes outstanding. Attention will then be taken away from the minor question of the quantity of notes in the hands of the public to the vital question of the character of the credit granted and to the control and vigilance over the kinds of discounts made by a bank. From whatever angle we approach the banking business we are

[1] This suggestion, put out in 1910, was the essence of what became Federal Reserve Banks in the twelve districts.

[2] Later the Federal Reserve Board carried out this function.

always forced, sooner or later, to recognize that everything depends upon the quality of the discounts and the kind of assets held as a consequence of making loans. The measures recently put into force by the comptroller of the currency, such as more stringent examinations, are to be highly praised because they bear directly upon this general principle. It lies at the centre of all real insurance or protection to depositors; and it lies at the centre of our whole question of banking reform which aims to relieve us of the disasters of sudden and forced liquidation in a time of panic.

CHAPTER VIII

POLITICAL HISTORY OF THE FEDERAL RESERVE ACT

§ 1. The Aldrich-Vreeland Act of 1908,[1] passed largely for political effect and expiring June 30, 1914 (later extended to June 30, 1915), was the cover under which preparations were made for a thorough revision of our currency system. That act was negative in its working, and before the European War no resort was ever made to its provisions for issuing emergency notes through currency associations. In the autumn of 1912 and 1913 the tension of credit was probably as extreme as in 1907, but, as was to have been expected, no use was made of the act.[2] The essential theory of it was the obvious dependence on an issue of bank-notes as the remedy for a stringency; while, in truth, the difficulty lay in the shortcomings of our credit organization. Deeper than the inelasticity of the bank-issues lay the inelasticity of credit and of the power to lend. It is interesting, therefore, to watch the development of reform proposals and to see how far they showed an understanding of the real weaknesses of our banking and monetary system.

The formation of currency associations under the act of 1908 had been urged by Secretary MacVeagh[3] on the various clearing-house centres; but although formed

[1] For a full study of this law, see Chapter IV.

[2] A considerable issue of Aldrich-Vreeland notes was made in the crisis of 1914, after the act had been amended by the Federal Reserve Act of 1913, and also by legislation in August, 1914. *Cf.* Laughlin, *Credit of the Nations*, pp. 299–305.

[3] In 1910. See Fin. Report, 1910, p. 5.

they were organized with much scepticism as to their actual use. The tax on the notes was unintelligently heavy, making their use almost prohibitory. On the other hand, if resort had been made to these notes rather than to clearing-house certificates, they would have had the advantage of a circulation wider than the narrow field of the certificates. Since they could not, however, be used as lawful reserves by national banks, they would not, in fact, have touched the lending power of these banks as directly as did clearing-house certificates. If A could not get a loan or extension at Bank X, and transferred his account to Bank Y on the promise of notes to be obtained through a currency association, A might have used these notes to take up his obligation held by Bank X; the next day Bank X could have presented these notes to Bank Y as a demand obligation against cash reserves; thus they would not have been so useful as clearing-house certificates which could have been used in settling balances between banks. Yet, apart from the tax, some bankers believed that these notes would have been effective in time of stress. Certainly, by being paid out to the public, they might have prevented, to some extent, the drawing-down of banking reserves of lawful money. At the best they could have been only a palliative. Yet it should be noted that these notes, whatever their efficiency, broke with the past unmistakably by being obtainable on the pledge of other security than United States bonds.

The provision in the act creating a National Monetary Commission had important consequences. Its composition, however, was typical of our methods: the eighteen members were chosen equally from the two Houses of Congress, and practically none of them were experts.[1]

[1] It was at first proposed to have six members outside of Congress. *Cf.* p. 61.

Consequently, the education of the commission itself was the first duty, and a considerable number of treatises were prepared at the behest of the commission on topics more or less pertinent to the subject. The formation of a concrete plan of reform, however, came through the visits of the chairman and others to Europe and through some other influences at home. It is to the credit of the chairman, Senator Aldrich, that, in comparison with his attitude in 1908,[1] he performed a complete *volte face.* European experience, well known already to American students of this subject, was now driven home on those who might influence the action of Congress. But the definite outlines of the plan of the commission presented January 17, 1911, must have been due to the suggestions of a few experienced persons in this country, who were consulted by the chairman near the end of 1910.[2] Whatever its origin, the plan actually laid before the country by the commission had the distinction of attacking the pivotal weakness of our system—the organization of credit. That was an epoch-making advance. Into the personal and political animosities connected with the chairman of the commission it is needless to enter here; but in getting legislation it is obvious that political prejudices are facts as much as stone walls, and they had their due influence on the result.

§ 2. In fact, political considerations were ruling in regard to a subject which of all others ought to have had non-partisan treatment. During the campaign of 1912 every effort was made to keep the currency question out of politics. The fact, however, that the plan of the com-

[1] *Cf. supra*, pp. 54, 68.

[2] Besides Mr. Aldrich those most concerned in its making were, by common report, Messrs. Paul Warburg, F. A. Vanderlip, A. Piatt Andrew, and others.

mission was intimately associated with the name of Senator Aldrich, the head of the Protectionist Republicans, was present in every one's mind. This fact forced the question into politics. The commission, from the Republican point of view, made the fatal mistake of delaying the presentation of its report for four years until the Lower House became Democratic. The reaction in favor of the Democratic party made it patent that no bill unsatisfactory to the Democrats could become a law. But the demand for non-partisan action was still so great that even Democratic leaders believed that, while the matter could not be brought up in the winter session of 1911–1912, just before a presidential campaign, it ought to be taken up in the short winter session of 1912–1913 after the election. Political events, however, swept these hopes aside.

The Democratic convention at Baltimore saw a struggle between the conservative and radical elements of the party in which, in a sense, the latter won. Although Mr. Bryan could not control the result, neither could the conservatives. The nomination of Woodrow Wilson, who was not Mr. Bryan's candidate, created a situation that made it seem necessary to placate Mr. Bryan by allowing him to write the platform; and the currency plank arrayed the party against "the so-called Aldrich bill or the establishment of a central bank."[1] The danger of making the subject a party issue was diminished, however, by the Republican platform, which declared only in favor of general principles and not for any specific plan. Consequently, the currency issue was little heard of during the campaign of 1912. The eccentric declara-

[1] It has been claimed that the true draft was altered by the omission of the letter "f," and should have read "Aldrich bill for the establishment of a central bank."

tion of the Progressive platform drew no discussion. Very early in the campaign it became evident that Mr. Wilson would be elected. The election of a Democratic Senate later gave his party full control of legislation. Hence, Democratic leaders had no disposition to allow a currency act to pass in the short winter session, when they could very soon stamp their own impress on the most important problem up for solution since the Civil War—least of all a measure regarded as the handiwork of Senator Aldrich, a Republican leader.

While Mr. Wilson spoke of giving the question non-partisan treatment, he had elements in his party difficult to be unified on common ground.[1] As early as September, 1912, it was known that the Pujo subcommittee of the House, dominated by its counsel, Mr. Samuel Untermyer, intended to report specific monetary legislation in connection with the investigation of the "Money Trust." This policy infringed on the legislative work of the Glass subcommittee. The conflict finally ended in the triumph of Mr. Glass (who in the extra session of the new Congress, April, 1913, became chairman of the full Banking and Currency Committee). In the meantime, by the summer of 1912, the so-called Aldrich Plan (reported in January, 1911, to both House and Senate) seemed to have become politically dead. In November, 1912, the Glass subcommittee was spurred into activity by the work

[1] The radicals in the House, like R. L. Henry of Texas, wished extreme action in connection with the investigation of the "Money Trust," hoping to get useful campaign material. The resolution demanding this investigation was finally sent to the Banking and Currency Committee, where it was given to one-half of the committee presided over by Mr. Pujo, then the chairman of the whole committee; while the other half of the committee, to be presided over by Mr. Carter Glass, next in rank to Mr. Pujo, was intrusted with the definite task of preparing legislation on banking and currency. To Mr. Glass's subcommittee the plan of the Monetary Commission and other bills were also referred.

of the Pujo subcommittee. Up to that time, tentative Democratic banking bills did not go far, even proposing to leave untouched the existing inelastic national bank-notes secured by bonds. In fact, having seen divisions in the party because of silver and other monetary issues in the past, Democratic leaders were loath to take the chance of arousing discussion on these questions. Politicians hoped to dodge serious legislation by postponing it.

Meanwhile public opinion, developed in a systematic way, had become intelligent and insistent in favor of thorough and constructive legislation. Foreseeing that this could come only through the Democratic party, the South was made the objective of an active propaganda in favor of banking reform.[1] So vigorous and successful was this work that, later, a Democratic Congress found many of its constituencies demanding legislation of a sound, specific character. In the Sixty-second Congress, in the Democratic House, the radicals were outnumbered 2 to 1; and in the Sixty-third Congress the ratio was probably about the same. A Democratic Congress, therefore, called in extra session as early as November, 1912, by President-elect Wilson, had to face the problem

[1] The National Citizens' League for the Promotion of a Sound Banking System, with headquarters in Chicago, began a campaign of education throughout the country in June, 1910, giving main attention to the South, and to Progressive States in the West and Northwest. Effective organizations were established in forty-five States, chiefly among business men. Contributions were solicited from banks on the ground that they represented also the borrowing business public, who were mainly interested in the reform. A vast amount of material was printed in the newspapers and pamphlets, while a volume on *Banking Reform* (1912, 23 chapters, 8vo, pp. xii + 428) was published. For the man in the street simple exposition was supplied in a fortnightly issue and in newspapers; but the volume on *Banking Reform* was a text-book for use by editors, speakers, and congressmen. Speaking was had especially in the South. The purpose of this organized and systematic work was to create public opinion in the home districts, and it had the expected result in the final votes in Congress. The League stopped its work November 1, 1913.

from which there was no escape. Then Mr. Wilson's firm, guiding hand appeared. He was evidently advised of the progress already made by the Glass subcommittee, but he kept his own counsel. From the very date of the calling of the extra session in November, the chances of currency reform seemed suddenly to become favorable. To Mr. Wilson's championship more than to any other force was the final legislative result due. It came to be expected that a banking and currency bill would, if possible, be taken up in the extra session (spring of 1913); and the Glass subcommittee held hearings in January, intending to have a bill ready by the time the extra session convened.[1]

The still larger political significance of banking and monetary reform, however, cannot be disregarded. It is well known that the Democratic party had in past years sympathized with the pleas for unsound paper money, and had been committed to the free coinage of silver. The Republican party, it is true, was on its side responsible for the silver act of 1890. Fortunately, during the control of the Democratic party by President Cleveland his party was, with remarkable generalship, manœuvred into a position of soundness on the silver question. When Mr. Bryan gained control and enforced on his party his

[1] The Glass subcommittee was at work on the bill early in December, 1912; hearings were held in January, 1913; and the bill was practically outlined before the inauguration, and approved by President Wilson. In the extra session of the spring of 1913, the new House Committee on Banking and Currency had been named, with Mr. Carter Glass as chairman of the whole, only a short time before the House bill was introduced, June 18, 1913. The committee began work on the bill July 7; it was reported to the Democratic caucus early in September, ratified, reported to the House September 9, and passed by the House September 18. In the Senate, hearings were held on the bill until October 25; it was considered by the Banking Committee, of which Mr. Owen was the chairman, for a month; reported to the Senate December 1; debated until December 19; went to a conference committee, whence it was returned December 22; was passed and received the President's signature December 23, 1913.

views in favor of the free coinage of silver, and the issue of all paper money by the government (involving the substitution of government paper money for national bank notes), the Democratic party was successively beaten in every campaign which pivoted on those issues. It was not the strength of the Republican party, but the aberrations of the Democratic party on banking and currency, which drove a majority of the voters to elect Republican presidents. In view of the disasters which had come upon Democrats through monetary issues, it is easy to understand the reluctance of their leaders to take them up just when party success in the national elections seemed possible. Nevertheless, the development of industry in the South, and the spread of a business, rather than a political, point of view on currency questions throughout Democratic States brought a growing belief that only by passing a great constructive act on banking and currency could the Democratic party wipe out the distrust due to past eccentricities on those issues, and win that confidence from the business element which was essential to remaining in political power. The statesmanship by which President Wilson, with the aid of Democratic leaders, put their party behind an epoch-making, constructive measure and passed it on December 23, 1913, is a monumental event in our political history. It assumes the character of a political miracle. No little credit for the political result also should be assigned to Mr. Bryan, who brought his large following to the support of the measure. Hereafter, the political lines on money and banking questions must be drawn in entirely new ways; so that the effects of this act on both our business and our political development can scarcely be exaggerated.

§ 3. The preliminary draft of the Federal Reserve Act was formed by the subcommittee of the House Bank-

ing and Currency Committee, under the chairmanship of Mr. Carter Glass, in the winter of 1912–1913. The expert of this committee and afterward secretary of the Federal Reserve Board, H. Parker Willis, had probably more influence than any other man in shaping the measure in its formative legislative period. Inasmuch as the incubation of banking reform had been going on through the struggles of many years, the final result could not be traced to any one source or to any one man; but the main principles in it were already the common property of trained men in Europe and the United States. The real problem of statesmanship was in creating a bill which would meet the varying points of view of those in power and yet be sound; and the final act shows in many sections, as was inevitable, the evidences of struggle and compromise.

Mr. Willis, who was intimately acquainted with the events going on in the winter of 1912–1913, and in the months of active legislation during the following extra session, says of the origin of the bill:[1]

> It is not drawn, even largely, from any single source, but is the product of comparison, selection, and refinement upon the various materials, ideas, and data rendered available throughout a long course of study and agitation. Many bills embodying the same general line of thought that now finds expression in the new act have been offered in Congress; some have been suggested outside that body. The most fundamental concept of all—that of uniting the banks of the country into organized groups—is found in the clearing-house organizations,[2] which in time of stress have pooled their resources and converted bank assets into the equivalent of reserve money. . . . [The earliest of the bills found useful] was the bill recommended by the Indianapolis Monetary Commission, which did not provide for co-operative unions of banks, but upon which the framers of the present act have evidently drawn for some of their ideas.

[1] *American Economic Review,* March, 1914, pp. 13 *ff.* [2] *Cf. supra,* p. 149.

As to the indebtedness of the new act to the bill of the National Monetary Commission, Mr. Willis speaks as follows:

By many the new law is regarded as a partial copy of, or plagiarism from, the Aldrich Bill; and that view has been widely expressed both in and out of Congress. That such was not the opinion of Mr. Aldrich himself, his scathing and bitter denunciation of the House bill seems to bear abundant witness.[1] . . . The Aldrich Bill may be considered from two standpoints: (1) that of its theory and broad general plan on the one hand, and (2) that of its machinery and technic of construction on the other. From the first standpoint there is no shadow of relationship or similarity between the Federal Reserve Act and the Aldrich Bill. . . . The Aldrich Bill provided for a single central "reserve association"[2] with scanty public oversight. . . . The new act . . . leaves banking as such to be practised by bankers; it vests the control of banking in the hands of government officers. The theory and purpose of the new act are widely different from those of the Aldrich Bill. . . .

From the standpoint of technic . . . the case is quite different. With regard to stock-issues, kinds of paper eligible for rediscounts, and not a few other particulars, the Federal Reserve Act follows lines laid down in the measure which bore the name of Senator Aldrich. In fact, the original House bill, for strategic purposes, retained wherever it could safely do so, the language of the Aldrich Bill as regards banking technic, its framers recognizing that by so doing they enormously reduced the hold of the opposition. . . . Moreover, the most desirable features of the Aldrich Bill were found in its sections dealing with banking technic—upon which some of the country's best banking ability had been expended. . . .

A review of the detailed provisions of the measure shows, therefore, that, while the conception of banking reform upon which it is founded is the same that has constituted the staple

[1] *Proceedings of American Academy of Political and Social Science*, October, 1913.

[2] It was generally understood that the elaborate organization of the reserve associations and the system of control was the main personal contribution of Mr. Aldrich to the bill.

of the banking reform movement of recent years . . . the act as a whole is based upon a conception and plan entirely its own, applies in many fundamental respects methods of control and administration that have been given at least a new form, and includes several important innovations, not heretofore conspicuous in banking discussion, although admittedly significant, not to say necessary, to any thorough reorganization upon sound principles.

§ 4. In order to aid in bringing about early action by Congress the author drew up in January, 1913, a memorandum of the political situation, which was sent to the President-elect. Whatever its effect, its contents may now have some historical value:

The Glass subcommittee on currency and banking has undoubtedly framed a bill which could be soon given out, even though no action could be expected at this (winter) session (1912–1913). Public opinion throughout the country is more developed in favor of action than is realized in Washington. It would be an error of political strategy to delay legislation beyond the spring (extra) session (1913), for the following reasons:

1. To postpone it to the long session of 1913–1914 would bring congressmen face to face with a new election in the summer and autumn of 1914. If there is any hesitation now to treat the money question, it will be much stronger next year. That will probably mean another postponement.

2. There have been certain psychological times when monetary legislation was possible: (1) After the agitation by business men in 1898 (following the silver campaigns) legislation was passed March 14, 1900; (2) after the panic of 1907, the public expected action again, but this great opportunity was frittered away by the Aldrich-Cannon group—rigging only a jury-mast in the Aldrich-Vreeland Act of May 30, 1908, which is practically an expression of incompetence; (3) again, at the present moment public opinion, especially among business men, is becoming impatient, restive, and urgent, after the constriction of credit last autumn which was nearly as severe as in

1907. If legislation is not had at this juncture, it is likely to go over several years.

3. It is now six years since the last panic; a boom in the next twelve months would prepare the material of overtrading which might issue in an unexpected breakdown of credit in the next two or three years. Delay until another panic has aroused public opinion would be ruinous political policy.

4. The passage of tariff bills, on even one schedule, would certainly create more or less dissatisfaction with any administration; that is to be expected. To have the passage of a constructive measure on currency and banking to its credit, alongside of the tariff revision, would be an important offset to tariff criticism, because it would especially appeal to the business men of the whole country.

5. Whenever monetary legislation becomes imminent, inevitably countless plans are proposed, some good, most cranky, and persons become partisans to this or that plan, so that agreement is impossible on any one measure. Before such crystallization becomes possible, political sagacity demands the throwing of the party behind some bill (already thought out and accepted by the few who really lead). It would be a rallying-point. Not one in 10,000 will be competent to judge of the bill on its merits; given its large, essential high-spots, popularly put, men will accept it on authority.

6. The indication of the general features of the plan should come from Mr. Wilson to Congress and not from Congress to Mr. Wilson. He can speak for the people in demanding the socializing for the common good of a present strongly individualistic banking system.

7. The present is the critical moment. At the very time when the Glass subcommittee is nearly ready to report a bill, party leaders are obliged to consider the probable programme for the extra session. Those in the party who remember their disasters in past money campaigns are naturally disposed to urge delay. A dangerous situation may arise, if both sides begin to crystallize into antagonisms. It can be dissolved in a moment by six lines given to the public by Mr. Wilson, saying that banking and currency legislation should be taken up in the spring session. The desire for harmony in the party is so strong at Washington, and the will to help Mr. Wilson so

evident, that such a declaration by him to the country would break up division before it could occur, and all would fall in behind the party measure. Moreover, it is conceivable that the authority of a President may be greater now than later when patronage troubles may arise.

8. Finally, early publicity of the party bill is desirable. It will furnish a rallying-point; discussion and publicity will be concentrated on this to the exclusion of all lesser bills and theories. Moreover, by drawing criticism, it will afford opportunity for later perfecting the measure during its passage.

9. In a tactful way, for which Mr. Wilson is eminently fitted, some common understanding on the bill should early be arrived at by the forces needed to give the measure support. The measure of Mr. Glass is likely to afford a reasonable compromise with Mr. Bryan on government issues and asset-currency. Also, there is good ground for thinking that the National Citizens' League and the American Bankers' Association could be brought to support it, if its technical provisions are carefully worked out. Some informal conferences would settle all differences, which are now only matters of detail, and not of general principle. Thus an unmistakably active public opinion could immediately be created behind the party bill, if Mr. Wilson, from his coign of vantage, would give the word.

It may be that this memorandum had no effect on the decision of the President; but, whatever the reasons were which actuated him, the bill was in fact introduced and passed in the extra session. Still, if it were never even seen by the President, it presents briefly the political situation at the time as seen by one closely connected with the campaign.

§ 5. The actual result of the struggle has proved to be remarkably good; but the opportunity ought not to be let pass without comment on our American method of legislating on subjects requiring expert knowledge and experience. There is a certain assumption (with some rare exceptions) that election to the House or Senate of

our national Congress makes the member an expert on all subjects that may come before him. In other words, even the members of committees are not experts; and yet these members usually insist on introducing their personal convictions into proposed bills. Members often publish to the world by their questions an abysmal ignorance of the subject before them. Hearings are usually held, not primarily to have various sides of the problem presented by experts, but to enable the ignorant member to be taught and to understand some of the obvious parts of a proposed measure. In hardly any other country in the world would inexpert legislators attempt so to construct a bill. The matter would be first referred to a committee of impartial, trusted experts, whose report would then be thoroughly thrashed out by the legislators who are responsible to public opinion. Yet with us, the fact of election to Senate or House seems to create in the minds of those elected a suspicion of outside advice. Since men who are primarily politicians, and have little or no expert knowledge or training, must be personally convinced before a bill can even be reported from a committee, it is a perpetual wonder that workable laws on technical subjects are ever passed. What is the conclusion? The actual process of legislation is not what on the surface it seems to be. The bill is not passed on its merits; for very few of those who vote on it know anything of its merits. This outcome, it may be said, is the necessary result of committee government. Not wholly; because that theory assumes that committees are experts, which they are not. The conclusion is that an important act gets on the statute-books, in our political system, only as a part of a given party policy. The man in command of the party's fortunes, or the few leaders who work with him, agree on a measure and it is "put through"

by the dominant party, even though these leaders know very little of the subject. The system as thus described is probably the reason why our laws on currency and banking have been so defective; and it may also explain why, by a happy conjunction of events, a remarkably good act has been passed, although few of those who passed it really understood the essential features of it.

§ 6. The problem of banking and currency reform was complicated by a confusion of mind, even among bankers, in regard to the various kinds of banking which might be carried on by any one institution. We were in the midst of an evolution, not only in our business, but in our credit, organization. The banking organism, which had seemed fairly homogeneous, began to be resolved (as if by some gigantic magnifying-glass) into parts having separate functions and purposes. Already the trust companies, organized under State laws, while retaining their original departments, had developed departments for commercial banking creating demand-liabilities. Meanwhile national banks, although essentially commercial institutions, began to establish savings departments. Then, the growth of investment banking, and the promotion and distribution of securities to meet the phenomenal growth of savings by investors large and small, in a country of rapidly expanding wealth, assumed an overshadowing magnitude, and colored the whole character of American banking and finance. In addition, the fact, well known to economists, began to be recognized by Americans generally, that we had no institutions to cover the demands for agricultural credits in rural districts. The interrelations and analysis of these elements in our banking system are alluring and need a large treatment by themselves, but this must be

reserved for another time and place; it is possible here only to refer to them in order to get a fairly clear understanding of the new legislation of 1913.

Most of the national banks, as well as those under a State system, were carrying on two distinct kinds of banking under one management. The test of a commercial bank is that it creates demand-liabilities; consequently, it should hold only assets (chiefly the results of loans at short time based on actual transactions in goods) that are liquid and can be quickly or frequently converted into cash. The creation of demand-liabilities (chiefly in the form of demand-deposits) requires as a condition of sound banking a special kind of assets readily adapted to meet an instant demand for cash from customers. But the holding of investment securities by commercial banks has reached enormous figures; and any general demand for liquidation of long-time securities in cash could not be met; because an offer on a large scale would result in a great fall in the stock-market, in the weakening of collateral held for loans, and an impairment of all credits, without creating the coveted cash. The desire to share in the profits of promotions led commercial banks to tie up resources in non-liquid form, with the expected results in time of panic.[1]

This confusion between commercial and investment banking, which was characteristic of the great cities,

[1] The holdings of securities other than United States bonds by all national banks, on January 13, 1914, were $1,020,494,711, of which $566,246,910, or more than one-half, were held by banks in the Eastern States (New York, New Jersey, Pennsylvania, Delaware, and Maryland); $45,255,914 by the Southern States; $215,119,106 by the Middle Western States; $34,792,121 by the Western States, and $65,155,202 by the Pacific States. It is to be noted, however, that the national banks on the same date show savings-deposits (presumably time-deposits) of $855,914,458, of which country banks held $755,914,458. For a further study of the legality and policy of security holdings of national banks, *cf.* J. H. Hollander, *American Economic Review*, December, 1913, and J. V. Hogan, *Journal of Political Economy*, November, 1913.

found a counterpart in the small rural banks of the West and South. They too held investment securities; but they confused two distinct kinds of banking in a different way. National, as well as State, banks in rural communities created demand-liabilities; but because short-time commercial paper was often limited in supply, and because there were no institutions dealing with agricultural credits, the rural banks to a greater or less extent put their resources into paper based on land, or in non-liquid form. The confusion in regard to different kinds of banking in rural districts was thus matched by that in the great cities. The consequences were obvious: in the latter the essentials of reform were obscured by the hue and cry about "Wall Street control," which originated really from the prevalence of promotions and loans on securities; while in the former, the desire to help the under dog (or small bank) led to provisions for rural loans on land wholly inconsistent with the refusal to accept loans on stock-exchange collateral. Such is the way of legislation in a democracy.

CHAPTER IX

A PROPOSED BILL

§ 1. The author had been a member of the Indianapolis Monetary Commission and drew up the report of 1898; he had been called in to aid in preparing the bill of the American Bankers' Association in 1908; after the tentative draft of the Aldrich Bill was made, he, like many others, was asked for suggestions, but had nothing to do with its main formulation; and in 1911–1913, being charged with the conduct of a nation-wide campaign of education on banking reform,[1] he was also permitted to offer his own suggestions to the Glass subcommittee in the winter of 1912–1913. These suggestions were put into the form of a bill with a running commentary on various sections. Moreover, while fully understanding that no one draft was likely to be adopted *in toto* by the framers of the new legislation, he was led to present a complete bill containing in it some features, especially regarding the note-issues, which were too ideal to get into this law; but these provisions are here retained as part of the material out of which the general result was created. They may have some bearing on the banking development of the future. It may be that some of his suggestions were incorporated in the final act, but he was content with throwing his material into the common pot, out of which an admirable and lasting piece of legis-

[1] He was chairman of the Executive Committee of the National Citizens' League, whose ruling board was composed of Chicago business men. He also had valuable aid in this work from Professor W. A. Scott, of the University of Wisconsin, and Professor M. S. Wildman, of Stanford University.

lation emerged. By presenting in this chapter his proposed bill[1] (for which, although aided by many others, he assumes all responsibility), it can easily be compared by the student with the Federal Reserve Act. Apart from technical banking provisions, of course the main interest centred on questions of organization and control, including the matter of centralization; elasticity and security of note-issues; the elasticity of credit; the transition from the old bond-secured circulation to the new systems; the co-operative holding of reserves; foreign banking; and clearings under a new system.

§ 2. Out of the discussion on currency reform for the eighteen months preceding December, 1912, there had been reached on certain points a general agreement, which may be briefly summarized:

1. The need of some co-operative agency for rediscounting commercial paper in time of pressure, in order to prevent panics. This would supplant the partial, voluntary work of clearing-houses in the past.

2. A cessation of the present scattering of reserves, and their mobilization in the common interest of all banks.

3. A control over the possible expansion of credit and the speculative use of idle funds. Control of the rate of discount.

4. An elastic currency. The abolition of the system of bond-secured national bank notes.

5. Bankers' acceptances of commercial paper to be allowed to national banks.

6. The co-operative discount institution to be made the fiscal agent of the United States Treasury.

7. Banking institutions to be established in foreign countries to aid American trade.

[1] As to the charge that this bill was a disguised form of the Aldrich Bill, any one who had read both would see the falsity of the charge. *Cf.* also the attack on this bill in the hearings before the Senate Committee on Banking, 63d Congress, 1st session, part 23, p. 1811, and part 38, p. 3013.

Banking reform was tied up with currency reform, because banks in this country provide a currency in the form of checks drawn on deposits, and because the question of the organization of credit is even more important than the issue of bank-notes. The unnecessary expense of obtaining credit under a bad banking system is borne by the borrower; the impossibility of getting loans in a time of stringency, or panic, shuts up factory and shop and falls most severely upon the wage-earner, who loses his employment. The defects of our banking and currency system are obvious.

It has long been seen that our currency is needlessly inelastic; that our credit system is even more dangerously inelastic; that our large gold supply is ineffectively used; that the scattering of reserves forbids co-operative action by the banks in time of stress; that our rigid reserve system even breeds panics; that State banks and trust companies are doing commercial banking, but without co-operation with national banks; that our independent subtreasury often attacks the reserves of banks at times of danger and works without businesslike economy and efficiency; that idle funds of banks drift to New York, and on call loans feed stock speculation; and that our trade is greatly hampered by lack of American banking facilities in foreign countries.

The defects of the present currency system are so obvious that there is a general consensus of opinion that something must be done. Legislation of some sort is inevitable. The Monetary Commission Plan has been politically antagonized. Some other plan, different but sound, must be brought forward; one whose control could not pass into the hands of an ambitious financial group. The present problem, therefore, is to find the best concrete machinery for carrying out the points on which there is pretty general agreement.

The emphasis of the opposition has been put on the fear of control by "Wall Street." It is a question, therefore, whether any organization is possible, which would give the necessary oversight of the rediscounts in all parts of the country and the mobilization of the reserves to be directed in the common interest at the place of weakness and danger. In short, can we have an organization somewhat like a central clearing-house, which would do for all the banks in the country what a clearing-house association now does for the banks in one city? If so, the mechanism must be so simple that attempts to control it would be instantly perceived and be immediately frustrated. In order to prevent possible domination, either considerable government control (which runs the risk of the greater danger of political control), or some division of the agencies of rediscount into local organizations, like present clearing-houses in the main cities, or trading centres, have been proposed. Perhaps, the true solution lies between the two: the relegation of discount-making to branches or local institutions, with managers chosen by local boards, but who would be under supervision by some general board; and, then such government supervision of this board as will assure freedom from any dominant financial control, but not going so far as to allow any interference from politics. Unity of action is indispensable; but so is freedom from domination by any selfish political or financial interests.

§ 3. The reorganization of our credit system along democratic lines, at the same time that an elastic currency is provided, demands nothing novel or disturbing, if it be accommodated to what has already been evolved out of our experience. In brief, this accompanying measure is built up on the basis of our clearing-houses, in which we find there has grown up a mechanism to meet prac-

tical difficulties which has not yet been overtaken or recognized by legislation. By building up the co-operative discounting institutions upon the basis of the existing clearing-houses of the chief trading centres of the country, we regularize extralegal and voluntary operations which have grown to enormous importance. This bill simply attempts to keep pace with the past growth of experience; it does not overthrow; it supplements; and puts under legal direction what is now under private control, although quasi-public in character.

Because of the lack of any regulation of credit, clearing-houses grew up of necessity. They perform two functions: (1) offsetting of checks drawn on or against the banks of a city, obviating all payments but balances; (2) from this co-operation the banks were led into a far more important co-operation, to help out a weaker member by combining resources and issuing clearing-house certificates when the credit system had broken down. This last was a rediscounting operation, turning banking assets into a means of meeting clearing-house balances.

It has been charged that favoritism, or injustice, to banks has crept in, which could not be controlled, because clearing-houses were voluntary, unincorporated, extralegal institutions. If so, this bill, which establishes district associations upon, and in lieu of, the chief clearing-house associations, would regularize all such operations and bring them under the supervision of the government.

Because each district association is solely a discounting institution—devised to accomplish the reorganization of credit under the direction of law—it must have its own capital drawn from its membership in its own section. This arrangement localizes control in making loans, and requires democratic equality of treatment for every bank in a given district. It admits State as well as national

banks. As banks in a city co-operate to secure protection in the common interest, so the banks in a district (of which districts there may be five or more) co-operate to prevent selfish individualistic grasping for reserves in a time of alarm. In this way reserves are mobilized for a large section of the country so that no legitimate borrower in that territory need fail in getting credit and the means of payment, no matter what the stringency may be. Moreover, loans are limited to mercantile business, and not granted for stock-exchange transactions.

Therefore, unity of action and equality of treatment throughout the country demand, in addition, much the same supervision of all the district associations as the individual banks receive in any one district. It is proposed to gain this end by a general supervisory board, called the treasury board, without any capital. In brief, the treasury board co-ordinates the various district associations much as a clearing-house committee co-ordinates the banks in any one city. Thereby the fangs are drawn from any objection based on the possibility of one centralized institution, with a large capital, which might be dominated by "Wall Street" or by any selfish interest. The selection of this supervisory treasury board is made simple and plain enough to be free from all suspicion. It should provide for an equal representation by the three interests affected by the bill: (1) the bankers, (2) the borrowing business public, and (3) the government of the United States.

Having thus provided for the reorganization of credit, the elasticity of the currency is obtained in connection with the discounting agencies, the district associations, but through the treasury board in such a way as to throw the limelight on the safety and management of the note-issues. It is admitted by all that the bond-secured na-

tional bank notes are inelastic and should be abolished. The first alternative is the retention of note-issues by the individual national banks, based solely on general assets. To avoid the "asset-currency" of individual banks, this bill takes the issue of notes away from the individual banks and places it in the hands of the treasury board under the close supervision of the government—while yet making them safe beyond question by a lien on all the assets of the district associations. Thus all the expense of redemption and of reserves is put upon the banks and not upon the government, while the supervision is in the body in which the government is fully represented. This outcome is an obvious compromise between issues solely by banks and issues solely by the government. Such an adjustment may possibly be found in the accompanying bill.

§ 4. An act to introduce into the banking and currency system of the United States elasticity of credit and circulation through the establishment of district associations and a treasury board.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled:

Sec. 1. That the Treasury Board of the United States be, and is hereby, established in Washington, in the District of Columbia, to consist of the Secretary of the Treasury, the Comptroller of the Currency and five other members, of whom four shall be appointed by the President of the United States. The fifth member shall be chosen by the Board as already constituted, and, with the approval of the President of the United States, he shall be the chairman of the Board and the manager thereof. The manager shall hold office for ten years unless previously removed for cause by the President, or by a two-thirds vote of the other members of the Board. The Manager shall receive a salary of twelve thousand dollars per annum. The four members appointed by the President shall hold office for five years, and may be reappointed, and each of said ap-

pointees shall receive a salary of eight thousand dollars per annum. The term of service of members of the Treasury Board shall date from the day when this act shall go into force.

Sec. 2. That there shall be established in any centre of trade in the United States which may be designated by the Treasury Board, a District Association for a term of twenty years from the date when this act shall go into effect. At the expiration of said term of twenty years, if this act has not been specifically repealed, said District Association shall continue for another period of twenty years, and unless said act has been repealed at the end of a second period of twenty years, said Associations shall continue in existence until said act may be repealed; *Provided*, however, that Congress may alter or amend the provisions of this act to take effect at the end of successive periods of ten years after its passage.

Sec. 3. Each District Association shall have an authorized capital, divided into shares of $100 each, equal in amount to 10 per cent of the paid-in capital and surplus of all qualifying banks constituting its membership, as hereinafter indicated, of which capital 5 per cent must be paid in in cash before it is authorized to begin business. No District Association shall be given a certificate of incorporation, or be allowed to begin business by the Treasury Board, unless the total amount of its paid-up capital shall be equal to, or shall exceed, $10,000,000.

Sec. 4. Within thirty days after the passage of this act, the Treasury Board shall inform each national bank and each bank and trust company incorporated under the laws of any State or of the District of Columbia of the conditions prescribed for membership in said District Associations. Said Treasury Board shall designate the cities, or trade centres, in which a District Association shall be placed, and define the territory of each, indicating the District Association of which each qualifying bank or trust company shall be a member.

Sec. 5. In order to qualify as a member of a District Association, a national bank, or a bank or trust company doing a commercial banking business incorporated under the laws of any State or of the District of Columbia, must conform to the following requirements:

1. It must have subscribed to the stock of its District Association, as designated by the Treasury Board, an amount equal

to 10 per centum of its paid-in capital and surplus; and it must have paid in, in such manner as may be indicated by said Treasury Board, in full legal tender money or national bank notes, one-half of the capital stock thus subscribed.

The subscriptions of a bank or trust company incorporated under the laws of any State or of the District of Columbia to the capital stock of a District Association shall be made subject to the following conditions:

That (*a*) if a bank, it shall have a paid-in and unimpaired capital of not less than that required for a national bank in the same locality; and that (*b*) if a trust company, it shall have an unimpaired surplus of not less than twenty per centum of its capital, and if located in a place having a population of six thousand inhabitants or less, shall have a paid-in and unimpaired capital of not less than fifty thousand dollars; if located in a city having a population of more than six thousand inhabitants and not more than fifty thousand inhabitants, shall have a paid-in and unimpaired capital of not less than one hundred thousand dollars; if located in a city having a population of more than fifty thousand inhabitants and not more than two hundred thousand inhabitants, shall have a paid-in and unimpaired capital of not less than two hundred thousand dollars; if located in a city having a population of more than two hundred thousand inhabitants, and not more than three hundred thousand inhabitants, shall have a paid-in and unimpaired capital of not less than three hundred thousand dollars; if located in a city having a population of more than three hundred thousand inhabitants and not more than four hundred thousand inhabitants, shall have a paid-in and unimpaired capital of not less than four hundred thousand dollars; and if located in a city having a population of more than four hundred thousand inhabitants, shall have a paid-in and unimpaired capital of not less than five hundred thousand dollars.

2. It must carry such reserves as are required in Sec. 28 of this act, comply with all the regulations regarding reports and examinations, or any other regulations imposed by this act or involved in the execution of its provisions, and promptly meet all its obligations to its District Association.

3. If a national bank, it must present a certificate from the Comptroller of the Currency that its affairs have been in good

order for the preceding twelve months; if a State bank or trust company, it must present a similar certificate from the banking department of its State.

4. Any qualified bank or trust company may withdraw from membership in its District Association by giving 60 days notice in writing of its intention to withdraw, and by meeting all its obligations to the Association, including the payment of its *pro rata* share of any losses that may have occurred. Said Association shall be allowed four months after the actual withdrawal in which to repay to said withdrawing member its contribution to the capital stock of said Association; but in no case shall more than the amount paid in to the capital stock of said Association be returned.

5. Upon the fulfilment of the conditions herein stated, the Treasury Board, through its duly authorized officer, shall issue to each District Association a certificate of incorporation, for a term of twenty years from the date when this act shall go into effect, duly countersigned by the Manager of the Treasury Board and the Comptroller of the Currency.

Sec. 6. Upon the issue to each District Association of said certificate of incorporation, as above described, said District Association shall become, and is hereby created, a body corporate, and as such and by that name, to which shall be attached the number of the District, shall have power:

First: To adopt and use a corporate seal.

Second: To have succession for a period of twenty years from the date of this act.

Third: To make all contracts necessary and proper to carry out the powers granted to said District Association by this act.

Fourth: To sue and be sued, complain and defend, in any court of law or equity, as fully as natural persons.

Fifth: To select or appoint directors and officers in the manner hereinafter provided and define their duties.

Sixth: To adopt by its Board of Directors by-laws not inconsistent with this act, regulating the manner in which its property shall be transferred, its general business conducted, and the privileges granted to it by law exercised and enjoyed, subject to the authority of the Treasury Board, as may be stated in this act.

Seventh: To purchase, acquire, hold and convey real estate as hereinafter provided.

Eighth: To exercise by its Board of Directors or duly authorized committees, officers, or agents, subject to law, all the powers and privileges conferred upon said District Association, subject to the authority of the Treasury Board, as may be stated in this act.

Ninth: To provide as far as possible for the clearing of checks and drafts between different qualifying banks and between different District Associations.

Sec. 7. The Board of Directors of each District Association shall be elected as follows:

The subscribing banks in each district, and exclusive of the banks which are members of the clearing-house of the city in which the District Association is situated, shall be divided by the Bank Commission or by the Treasury Board territorially into six groups, each of which groups shall elect one director; each bank having one vote.

Three additional directors shall be named by the clearing-house of the city in which the District Association is situated.

The Treasury Board shall select five more directors from a list of fifteen nominees chosen by the nine directors already elected, which nominees shall not be officers of any banking institution (directors of banks not being regarded as officers) and who shall represent the chief agricultural, industrial and commercial interests of the district.

The fourteen directors thus chosen shall select from outside their number a person who shall constitute the fifteenth member of the Board and be its presiding officer and manager of the District Association, provided this choice be ratified by the Treasury Board.

The term of office of the manager shall be five years, but he may be at any time removed for cause by the Board of Directors.

The Board of Directors of each Association shall also appoint an Executive Committee of not less than three nor more than five from its members, of which the manager shall be *ex officio* chairman.

An Examining Board shall be appointed by the Board of Directors of the District Association, who shall examine into and report on the condition of the qualified banks within the

district assigned to each, and shall furnish to the District Association all information necessary for the proper selection of the paper presented for discount.

§ 5. The provisions of the bill regarding discounts are as follows:

Sec. 8. The business of the District Associations shall be:

(*a*) To receive from any qualifying institution within its district deposits of lawful money and national bank notes.

(*b*) To discount to the extent that its resources and the provisions of this act permit for properly qualified institutions paper of the following kinds:

(1) Such notes and bills of exchange as have been received in the course of business, which bear the indorsement of the institution presenting them for discount and which mature in not more than 60 days, excepting such notes and bills of exchange as are issued or drawn for the purpose of carrying stocks, bonds, or other investment securities;

(2) Acceptances of national banks made in pursuance of the provisions of Sec. 10 of this act, or acceptances of other qualified banks, which are based on travellers' credits or on the exportation, or importation of the products of the soil, mines, or of manufacture, and which mature in not more than 90 days and bear the signature of at least one bank in addition to that of the acceptor;

(3) The direct obligations of qualified institutions under the following conditions: Application for the privilege of making such discounts, designating the amounts, the collateral offered and the institutions applying for them, must be made to the Manager of the Treasury Board. If in his opinion such discounts are required in the interests of the public, and if such opinion is approved by a majority vote of the Treasury Board, and, also, if such opinion is approved by the Secretary of the Treasury, the privilege may be granted, *Provided* the collateral pledged shall be of unquestioned soundness; and that the amount of the loan shall not exceed 75 per cent of the market value of the securities pledged.

The total amount of discounts granted to any one qualified

bank by any District Association shall not exceed a sum equal to the amount of the capital of said borrowing bank.

Whenever the amount of discounts granted to any one qualified bank by any District Association shall equal 50 per cent of its paid-in capital, any discounts in excess of said 50 per cent shall be charged a commission, as follows: between 50 and 60 per cent, one per cent; between 60 and 80 per cent, two per cent; between 80 and 100 per cent, three per cent.

Sec. 9. The functions of rediscounting, or the issue of clearing-house certificates, by existing or future clearing-house associations, are hereby forbidden, it being assumed that such functions of existing clearing-house associations are exercised solely by the District Associations.

Sec. 10. National banks are hereby authorized to accept drafts or bills of exchange drawn upon them, having not more than four months to run, accompanied by the documentary evidence of the nature of the transaction which must be based on the movement of goods from the producer to the consumer, and were not drawn for the purpose of carrying stocks, bonds or other investment securities.

Sec. 11. Each District Association shall have authority to fix the rates of discount from time to time, which rate when so fixed shall be published, and shall be uniform within its District, *Provided*, that the Treasury Board shall have authority both to veto any proposed changes, or to order changes, in rates.

Section 8 of the bill authorizes the district associations to render two kinds of services to the qualifying institutions in their districts, namely, the administration of their reserves, and rediscounting.

In the description of the paper which the district associations are to be permitted to discount, described in (*b*) (1), (2), and (3), the following points are important: The limitation of discounts to paper which arises from the general movement of goods from producer to consumer; the permission to discount both promissory notes and bills of exchange which answer this description; the requirement that all such paper must bear the indorse-

ment of the bank presenting it for discount; and that it must mature in sixty days or less. It is undesirable to introduce rigid definitions into the law which lead to difficulties that the experience with the National Banking Act shows have often arisen. Inevitably much must be left to the management. The phraseology used in Section 8 defining the paper has been the result of much consultation with practical bankers.

Some persons have doubted the advisability of permitting the district associations to discount promissory notes on the ground that such permission would allow, and perhaps encourage, the continuation of the confusion of commercial and investment banking now almost universal in this country, while the limitation of discounts to commercial bills of exchange and bank acceptances of a commercial character would discourage existing bank practices and help to remove this confusion by forcing banks to put pressure upon their customers for the purpose of bringing back into use again the old commercial bill of exchange. It would probably be difficult, however, and perhaps impossible to change business habits in this respect immediately, and if so, the district associations should not be prohibited from discounting promissory notes in the meantime. The desirability of setting some limit to the length of time during which discounts of this character are to be permitted, however, is worthy of serious consideration.

It is desirable that the district associations should confine their discounts to as short-term paper as possible, and sixty days seems to be a reasonable period both from the standpoint of the district associations and that of their customers. Of course this limitation does not rule out paper that has been drawn for longer periods. The requirement is that such paper must be within sixty days

of maturity before the district associations can rediscount it.

In some respects the permission granted in (*b*) (3) to discount the direct obligations of qualifying institutions is out of harmony with the spirit and general purpose of this act, which is to draw a sharp line of distinction between commercial and investment banking, and to connect the issue of currency with the former and to disconnect it from the latter. Under very strict limitations this section permits loans on investment, instead of commercial, collateral, and thus permits the issue of treasury notes and the expansion of bank credits against investment securities.

The danger of this provision consists in the fact that it leaves open a door of escape to banks that violate the principles of sound commercial banking. But in times of crises it would be difficult, if not impossible, to refuse such a bank the privilege described in this section. On the other hand, investment banking is not only perfectly legitimate, but just as necessary as commercial banking, and the two kinds are now, and are bound to continue to be, carried on together by most of the banks and trust companies of the country. It is possible that a bank or trust company whose practices had been conservative and beyond reproach, might find itself, as a result of very unusual and unexpected combinations of circumstances, in need of more cash than it could get through the rediscount of its commercial paper. Should such a bank be denied relief by its district association? It is in the belief that it should not, and that the granting of such relief under the limitations here imposed would not be dangerous, that this section has been included.

The purpose of Section 10 is to provide a form of commercial bill of the widest possible currency, namely, the

banker's bill already in such general use on European markets. It should be noted that the bill which it is the purpose of this section to create is not a *finance* bill (*i. e.*, a bill drawn not against a shipment of goods or securities, but being in itself essentially a loan), but a *commercial* bill of the same general character as the one described in Section 8. Such a bill would have to be accompanied by the same kind of evidence of its real commercial character as the acceptance or personal note of a merchant or manufacturer. Bills of this character could be readily negotiated on foreign markets, and could be used by the treasury board in replenishing its reserves in case of need. They would also be purchased by banks in this country whose loan funds were in excess of local needs and would probably take the place of bonds in the secondary reserves of banks.

Section 29, given later in the bill under investments, simply authorizes the district associations to make use of idle funds in case a sufficient amount of paper does not come to them in the form of rediscounts. In other words, it is permitted to solicit as well as to accept paper for discount.

The subject of a uniform rate of discount is treated in Section 11. In the discussion to date, objections have been made to a rate uniform to the whole country, fixed by a central agency in Washington, on the ground that in our big country there are great differences in banking and industrial conditions, and in the local supply of capital, consequently causing legitimate differences in the rates of interest in different sections. Then, too, if one rate were fixed for all sections, a rate, *e. g.*, current in New England, would encourage expansion in a distant Western district, and draw capital away from legitimate uses in conservative districts. In any case, however,

the rate in this bill is one only between the rediscounting district association and its member banks. It does not change the relations between the individual bank and its customer. But while recognizing that general differences in levels of interest may exist in different parts of the country, and that each district association may fix the rate within its district (subject to approval by the treasury board), this rate must be uniform to every bank within a given district. Thus, while securing equality of treatment for all banks, big or little, within any one district, it provides a suitable flexibility for differing conditions in a large country by allowing different rates in different districts.

§ 6. The functions of the treasury board are given in the following sections, additional to Sections 1 to 11:

Sec. 12. The Treasury Board shall appoint a Board of Examiners, consisting of three members, to report at any time upon the conditions of credit, the kind of business done, and the proper conduct of the discounts at each District Association, or of any individual bank; and said Treasury Board may authorize the employment of suitable assistance, if needed, for this work of examination.

Sec. 13. To assist the Treasury Board in the performance of its duties, there shall be established an Advisory Board to consist of representatives of the District Association, one such representative to be appointed by the Board of Directors of each Association, and ten other persons to be selected by said representatives from a list of twenty-one nominees named, seven each respectively by three committees representing respectively the leading agricultural, industrial and commercial organizations of the United States. The method of appointing said committees shall be prescribed from time to time by the by-laws of the Treasury Board.

The Advisory Board shall hold regular monthly meetings and special meetings whenever called by the Treasury Board.

Full reports of the operations of the Treasury Board during the preceding month shall be presented by its manager, and any member of the Advisory Board may offer criticisms or suggestions. The final decision on all matters, however, shall remain with the Treasury Board.

At all meetings of the Advisory Board, a quorum shall consist of a majority of all members. Each member shall be reimbursed for his reasonable travelling and other necessary expenses for attendance at each meeting on vouchers approved by the Treasury Board.

Sec. 14. Said Treasury Board shall establish an office with each District Association, under charge of its own official, in which may be held such papers, securities, Treasury notes, or cash of any sort, the property of said Treasury Board, as may be deemed expedient in connection with daily transactions, or with any transfer of funds from one District Association to another, or in the redemption of its Treasury notes.

Sec. 15. The expenses of the Treasury Board shall be paid by the District Associations out of their gross receipts in such a manner and at such times as the Treasury Board shall direct. Each Association shall pay such a portion of said expenses as its capital and surplus bear to the aggregate capital and surplus of all the Associations.

The board established in Section 1 is assigned, in subsequent sections, administrative and supervisory functions only, and hence needs no capital. The period of its corporate existence is made twenty years to correspond with that of the district associations described in Section 2. This period is long enough to give the institution a fair trial and not so long as to commit the country unduly to an untried experiment. It should be observed that no legislation is required to continue its existence beyond this period. It is possible that the right to revise the charter more frequently than once in twenty years should be reserved. The Canadian banking act may be amended by Parliament every ten years.

The name, treasury board, is not inappropriate inas-

much as the secretary of the treasury and the comptroller of the currency are the *ex officio*, and thus the only permanent, members of it, and inasmuch as four other members are to be named by the President. This name has the advantage of suggesting the connection of the government with it, and thus of inspiring public confidence in the notes it is authorized to issue.

In Section 11 the treasury board is given supreme authority over rates of discount, but at the same time an initiative in their determination is granted to the district associations. Should circumstances seem to demand, it is possible under the operations of this section that different rates might prevail in different sections, but at the same time this condition of things could be prevented or modified at will by the treasury board. This arrangement is probably safest for us under present conditions. Since the district associations are to do the discounting, under ordinary circumstances they will be in closest touch with the market and best fitted to fix rates in their respective districts. On the other hand, the treasury board will alone be in possession of all the data relative to the state of the gold reserves and the conditions of credit throughout the country as a whole, and should, therefore, have the power to order such changes in rates as these conditions demand. If uniform rates throughout the country prove to be feasible and desirable the treasury board can establish them. On the other hand, if such uniformity should threaten overexpansion in certain sections, and the undue concentration of the banking resources of the country there, the power to prevent it rests likewise with the treasury board.

As defined by this bill, it is the function of the treasury board to act as an instrument of control and co-operation

for the district associations. The board of examiners provided for in Section 12 is an important and essential part of the machinery for these purposes. The treasury board must have direct access at all times to the books of the district associations and be in constant touch with them. For these purposes written reports made to the board by these associations are, of course, necessary, but inadequate. An examining board such as is here provided would be the strong arm of the treasury board in the most essential features of its work.

The treasury board (Section 15) will have no independent source of income. The commercial paper, acceptances, and bonds transferred to it, as well as the gold and other forms of money, will remain the property of the district associations making such transfers, and the interest earned on them will be theirs. In all of its operations the treasury board will be simply their agent, and its expenses will therefore be properly chargeable to them.

In brief the functions of the treasury board may be summarized as follows:

1. To supervise as a body of experts the operations of the District Associations while leaving all direct discounting to the Associations; in fact, to represent the United States as a supervising body over banking and currency.

2. To advise against inflation or speculation in any one District, should it arise, and to have power for that purpose over the rate of discount.

3. To have the power to examine into the conduct of any District Association, or of any individual bank.

4. To act as an issue-agency for all the District Associations in common, and to hold and account for the protection behind the Treasury notes.

5. To act in the transition period as the agent for refunding

the 2 per cent United States bond (with the circulation privilege) into 3 per cents (without the circulation privilege) and the gradual change of bonds into gold behind the Treasury notes.

6. To bring about the substitution of Treasury notes for all national bank notes.

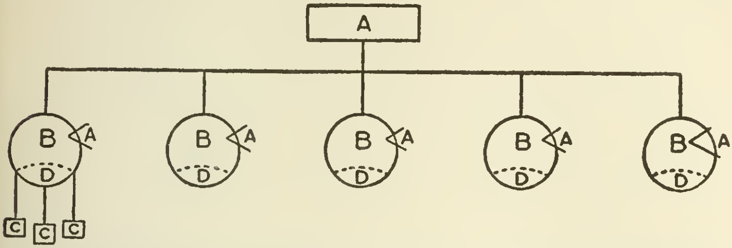
7. To publish combined and separate accounts for all District Associations once a week, and also weekly statements of the issue of Treasury notes and the assets behind them.

8. To watch over the gold reserves through the agencies of the District Associations, or to import gold, if needed.

In order to obtain the guidance and experience of men representing all parts of the country, an advisory board has been created to work with the treasury board. Local or sectional points of view will be mingled in the interests of the country as a whole through this agency. Moreover, there will be better opportunity to compare conditions of business and credit in all parts of the United States; and to receive advice as to making possible changes in the rate of discount.

§ 7. The district associations provided for in Sections 2–7 constitute the characteristic features of the plan upon which this act has been constructed, namely, that of the establishment of a number of regional banks, which, through the treasury board, will co-operate in matters of national import, such as the issue of notes, the administration of specie reserves, and the retirement of the national bank and the United States notes. Each regional bank will serve as a rediscount and reserve centre for the banks and trust companies of its district, and, through its connection with the treasury board, will make these banks and trust companies parts of a national organization through which our currency and credit system may be properly regulated and controlled. The

relation of the district associations to the treasury board may be best expressed by the accompanying diagram:



A = Treasury board, or the agency of *B*, *B*, etc. An agency for issuing notes, holding protection behind notes, having no capital, having general supervisory powers over rate of discounts, etc., and under close government supervision.

B, *B*, *B*, etc. = District associations, rediscounting agencies for the individual banks, *C*, *C*, *C*, etc.

D, *D*, *D* = Reserves of *B*, which might be the notes of the treasury board *A*. The reserves of *C*, *C*, *C* should not be treasury board notes, but gold or lawful money. This rule would force treasury notes back for redemption when not needed by the public.

A, *A*, etc. = Offices of *A* at each district association, where notes would be redeemed, or commercial paper exchanged for notes.

The bill provides for the performance of the chief functions usually possessed by a central bank through local institutions centrally supervised and controlled in so far as the proper functioning of our national currency and credit system requires such supervision and control. The capital of these associations should be proportional to the amount of business they are likely to be called upon to perform. Inasmuch as they will have as working funds, in addition to the amounts paid in by stockholders, the reserves deposited with them and the proceeds of collections, and inasmuch as the proceeds of rediscounts will, to a considerable extent, be left on deposit to be used for clearing and transfer purposes, it seems probable that a capital stock equal to 10 per cent of the capital and surplus of the banks and trust companies of the district will be entirely adequate.

The size of the districts must be determined chiefly by the convenience of banks and this will depend to a considerable extent upon facilities for transportation. It seems clear, however, that no district should be so small as to be unable to supply the association with a capital of at least $10,000,000. Probably most of the districts would be much larger than this, and in some cases it will probably be necessary to have several rediscount offices under the supervision and control of one district association. Inasmuch as it is wise to start with a small number of associations so that each would command respect for stability and resources, and inasmuch as one of these would cover a considerable geographical area, there would be additional reasons for establishing agencies of an association within any one district for convenient operation of its business.

The separate incorporation of each district association (Section 6) will be necessary since each is to be an independent organization with a capital of its own federated with other independent organizations of the same kind. It should be noted that among its corporate powers is that of acting as a clearing institution. The manner in which this function is to be performed is described in a subsequent section.

In the plan here suggested (in Section 7) for the choice of the directorates of the district associations, three desiderata have been held in mind, namely, efficiency, democratic control, and proper connection with the treasury board. In order to be efficient, these boards must consist of men who know intimately the agriculture, commerce, and industry of the section. The bankers are best fitted to select such men, since they alone know them all and know them intimately, especially in their financial relations, which are here most important. It is for this

reason and because other practicable methods did not suggest themselves that the actual selection of some and the nomination of all the directors is put into the hands of organized banks and clearing-houses.

Democratic control is secured, firstly, by providing for representation of all the interests concerned, the local banks whose paper is to be discounted and whose reserves are to be administered, the clearing-house of the city in which the main office of the association is located (which is interested in the same way that other banks are, and additionally because the association is to conduct inter-municipal clearings), the farmers, merchants, and manufacturers of the district who must use the banks and trust companies in the every-day conduct of their affairs, and the treasury board, which represents the government and the people as a whole and has general controlling and supervising powers over all the associations. Secondly, no one of these groups of interests is given control of the institutions; no action can be taken without agreement between at least two of them; and, thirdly, absolute equality between the voting institutions is secured, the number of banks and trust companies in each voting group having equal power, and each bank and trust company within each group being given the same voting rights and privileges regardless of its size. In such an organization big banks could have no advantage over little ones, and no kind of coercion could be exerted.

The treasury board cannot perform its functions unless there is complete harmony of action and policy between it and the district associations. This is here secured by giving said board the power to choose as directors five representatives of the agriculture, commerce, and industry of the section from a list of fifteen candidates selected by the other directors. If it is thought best to

increase the power of the treasury board, a further provision might be added to the effect that in case five persons satisfactory to said board could not be found among the fifteen first nominated, other nominations must be made until a sufficient number of satisfactory persons are found.

The examining boards provided (in Section 7) will constitute a very important part of the machinery of the district associations. Their chief functions will be to aid in the selection of the paper offered for rediscount and in securing the enforcement on the banks and trust companies of the country of the regulation and practices prescribed by this act and involved in its operations. Banks will also need support and assistance in the process of putting their business on a commercial paper basis, and these examining boards should be of great assistance in this direction. The efficiency of such boards has been demonstrated by the clearing-house associations of our large cities, and there is no good reason for believing that boards here provided for would not be equally efficient.

§ 8. In regard to note-issues this bill went further than political opinion in Congress was likely to go. Nevertheless, European experience has pointed out methods by which we might have provided an ideal system of our own. Consequently, the provisions of the bill on this subject are in advance of what might be politically possible. The sections on note-issues are as follows:

Sec. 16. At the office of the Treasury Board in Washington shall be established an Issue Department, and the accounts of the Issue Department shall be separately kept and so published weekly.

Sec. 17. To the Department of Issue of the Treasury Board shall be transferred by the District Associations all the

United States notes and national bank notes paid in for capital stock, or received on deposit by the District Associations from any source; and, also, all gold coin and gold certificates received by the District Associations which are not retained for their daily demands. In return, said Department of Issue shall issue to the respective District Associations a like amount of the notes of the Treasury Board in denominations to be fixed by said Treasury Board, and designated "Treasury Notes," or at the option of said Association credit the amount to its account.

The Treasury of the United States shall likewise transfer to the Treasury Board in exchange for Treasury notes all the United States notes and national bank notes that come into its possession.

The United States notes and national bank notes thus received by said Department of Issue shall not be paid out again, but shall be held until disposed of in the manner hereinafter indicated.

Sec. 18. The national bank notes received by the Issue Department of the Treasury Board shall be debited in a special account to the banks which issued them and the amounts thus debited shall from time to time be certified to the District Associations with which such banks do business. Whenever any District Association has received from such a bank United States bonds to secure circulation in accordance with the provisions of Section 23 of this act, it shall transfer to the Treasury Board an amount of such bonds equal to the notes debited as above indicated to the account of that bank on the books of the Issue Department of the Treasury Board, and said bonds when so received shall be credited at par to the note account of said bank, and the notes of said bank in like amount be cancelled and destroyed.

Sec. 19. The Treasury Board may also receive for the Issue Department from District Associations selected commercial paper of the kind previously described (Section 8) which has not more than thirty days to run, in amounts received from the several District Associations in proportion to the needs and condition of business of each District, as adjudged by said Treasury Board, and said Issue Department shall issue to the respective District Associations in return an amount of its Treasury notes equal to 95 per cent of the value

of said commercial paper, *Provided* that at all times the amount of gold certificates, gold coin, or gold bullion in the reserves of said Issue Department shall not be less than one-third of the total Treasury notes issued, and *Provided* that the amount of commercial paper thus received from any one District Association shall not exceed twice the amount of its capital and surplus.

Sec. 20. The notes of said Treasury Board shall be redeemable on demand in gold coin, or gold certificates, at the option of the holder at its office in Washington or in its office at any District Association.

All notes redeemed by the Department of Issue shall be cancelled and not reissued.

To provide the means for redemption in gold, the Treasury Board may exchange its Treasury notes for any gold coin, gold certificates, or gold bullion in the hands of the District Associations; or it may present any United States notes in its reserves to the Treasury of the United States, which shall give gold in redemption of said notes, *Provided*, however, that the Treasurer of the United States shall not pay out the notes thus redeemed except to the said Treasury Board in exchange for gold coin, or gold certificates, which exchange shall be made at the option of the said Treasury Board as soon as its gold holdings shall warrant such exchange; or, it may offer any of the United States bonds held by it, not having the circulation privilege, under the refunding clause hereinafter described (Section 24), for sale for gold, or it may use them as a basis for a loan of gold, upon such terms as may be agreed upon jointly by the Executive Committee of said Treasury Board and the Secretary of the Treasury; or, it may receive from the District Associations in return for its Treasury notes, the proceeds in gold arising from the discount or hypothecation by the District Associations of any gold exchange, or any bills of exchange, in the hands of said District Associations; or, it may purchase in exchange for treasury notes from District Associations foreign bills of exchange; and it may sell in foreign markets for gold any of said bills of exchange, or any of the commercial paper or acceptances in its possession.

Sec. 21. The circulating notes of the Treasury Board shall be received at par in payment of all taxes, excises, and other dues to the United States, and for all salaries and other debts

and demands owing by the United States to individuals, firms, corporations, or associations, except obligations of the Government which are by their terms specifically payable in gold, and for all debts due from or by one bank or trust company to another, and for all obligations due to any bank or trust company.

Sec. 22. In addition to the cash reserves, the United States bonds, and the commercial paper held by the Issue Department of the Treasury Board, held as security for the redemption of said Treasury notes, the aforesaid Treasury notes emitted by said Issue Department shall be a first lien on all the assets of the several District Associations in the proportion that the capital stock of any one District Association bears to the total capital stock of all the associations.

In explanation of the plan of note-issues thus presented, various considerations should be kept in mind.

Elasticity in our hand-to-hand currency is one of the chief objects to be attained through the treasury board. Contraction as well as expansion is an essential of elasticity. A part of the machinery for that purpose is provided in Section 20. The redemption of the treasury notes in gold is not only a means of maintaining their constant parity with gold coin, but of reducing the volume of the currency in case it exceeds the needs of commerce. Gold is a commodity useful in the arts as well as in the medium of exchange, and the presentation of treasury notes for gold and the use of the gold thus obtained for non-monetary purposes or for hoarding would reduce the volume of the circulating medium.

Another and still more efficient means to the same end is the withdrawal at maturity by the district associations of the commercial paper transferred to the treasury board (see Section 19). In case the circulating medium became excessive, such withdrawals would exceed in amount the current transfers of commercial paper to the treasury board in exchange for notes, and the only means of meeting this excess would be the transfer to

the treasury board of an equivalent amount of the treasury notes or of legal-tender money withdrawn from circulation. The treasury notes, when withdrawn, would be cancelled and destroyed, and the legal-tender money held in reserve.

At this point the question may be raised (Section 21) whether the treasury notes should be made legal tender for all purposes except payments by the treasury board and the district associations. There seems to be no good reason for giving them this quality. Being redeemable in gold on demand, they will circulate readily without being legal tender, and it is desirable to encourage in every way their presentation for redemption whenever there is the least redundancy; and depriving them of the legal-tender quality to some extent at least offers such encouragement.

The security of the treasury notes issued under the authority of this act will be beyond question (Sections 19–22). They will be completely covered by gold and other forms of legal-tender money, by United States bonds, and by short-time commercial paper which has passed the scrutiny of both district associations and the treasury board, and which bear the indorsement of the institutions which presented them for rediscount. Losses on such paper, if any should occur, would fall upon the district association which deposited it with the treasury board as security for notes issued. It is not possible that such losses would be large enough to affect appreciably the resources of any association. The first lien on assets here provided for is probably unnecessary, but it will put beyond question the public confidence in the safety of the notes. In the end, with the gradual disposal of United States notes and bonds, the protection to the notes would tend to become more largely gold and commercial paper.

Section 19 provides for a minimum gold reserve of one-third against note-issues. All issues not covered by gold would be covered by the special reserves of greenbacks and national bank notes held by the treasury board pending their retirement, by bonds acquired in the manner indicated in the preceding section, and by commercial paper maturing in sixty days or less. The treasury board could enlarge its gold reserve at any time by selling its bond holdings, by transferring greenbacks to the treasury for redemption, by selling abroad such of its commercial paper as might be there negotiable, by collecting its foreign bills at maturity or rediscounting them on foreign markets, or by borrowing gold on the security of its bonds.

The transfer of commercial paper to the treasury board as herein provided would constitute the principal means in the possession of the district associations of replenishing their cash resources. Another means would be the presentation to the treasury board of treasury notes for redemption in gold, and a third would be the deposits of cash made with the associations.

Maintaining one reserve for both demand-liabilities—notes and deposits—was the characteristic of early banking in the United States when checks drawn on deposits were much less used than bank-notes. The two United States Banks were types of this kind, as were also the banks under State charters before 1838. Such a type of bank reflected the rural conditions of the time and the habit of using chiefly notes or coin as a medium of exchange. After the New York Free Banking Act of 1838, separate assets were pledged for the notes. This plan was improved upon and adopted into our national banking system; but notes secured by United States bonds, while safe, proved wholly inelastic. The Bank of France is of the same type as were the two United States Banks of

our early history, having but one reserve for both notes and deposits; and for the very good reason that in France notes, not checks drawn on deposits, form the chief medium of exchange. Much the same is true of the Reichsbank.

The development of our own banking habits and the characteristics of our business methods require a system different from that of these Continental banks. If any European example may suggest methods to us, it would be that of Great Britain, which is the only other country that has a fully developed credit system like our own; it is the only other country that uses chiefly the deposit-currency, instead of notes, as a medium of exchange. The problem in the United States is much more the organization of credit through the elasticity of lending power (carried out by using checks drawn on deposits which arise from loans) rather than the mere elasticity of notes—although the two are intimately connected together. Hence, the wisdom of so separating the functions of issue and discount that, while their interdependence is clearly accepted, their distinct operation may be seen and their dangers and merits made entirely public. The silent education which will come from the separate publication of the issue and discount statements is not the least of the advantages of this provision.

In Sections 16–20 it is intended to transfer the note-issuing function from the existing national banks to an issue department in the treasury board.

It is assumed that bond-secured notes are so inelastic and undesirable that they will not be continued. In place of bonds, what security shall be provided? There are in the main the following alternatives:

(1) Substitute the general assets of a bank for bonds and leave issues, as now, to the national banks.

(2) Allow bonds, securities, etc., other than United States

bonds, as security, as is provided by the Aldrich-Vreeland Act in effect through currency associations; and still leave issues to the individual national banks.

(3) Take away the issues from the national banks and entrust them to some agency acting for all the banks, and secure the notes by cash reserves, some United States bonds, and a flexible amount of selected commercial paper, sent in by District Associations.

(4) Retain existing national bank notes, but allow in addition District Associations to issue notes based on deposit of bonds or commercial paper.

(5) Substitute Government issues for national bank notes. These notes to be the promises to pay of the United States, but transferred by the Treasury to District Associations when needed by them in rediscounting for individual banks.

(1) To allow a national bank to use any of its existing assets as a basis for note-issues implies a trustfulness in the character of the paper held in every bank, in any part of the country, which is not warranted. Such a plan would result in notes as varied in soundness as the managements of the different banks. Even if the notes were limited to a percentage of the bank's capital, this objection would still hold. To take away the security of United States bonds is to remove the very element which gives uniformity of value to the national bank notes in all parts of the country; and we thereby retrograde to the faulty protection of most State bank notes from 1838 to 1864.

Moreover, the permission to each national bank to issue notes based on its general assets, without close supervision over them, would lend itself to undue expansion, even if there were a restriction to some percentage of issues to capital. If such issues were safe, there should be no restriction on the amount of notes except the needs of the public (subject to contraction arising from immediate redemption in gold). So long as our present

reserve system continues, the danger would exist that a surplus of bank-notes would remain in circulation, instead of being redeemed and retired, while a corresponding amount of legal tenders would be forced into bank reserves as hoards. Once reserve funds were thus increased, expansion would be almost certain to follow.

Further, the State banks ought to be treated equally with national banks as regards issues as well as discounts. The withdrawal of the issues from individual banks, and their assumption by a single agency in behalf of all the banks, would be a protection against ill-advised action by any individual bank, and yet secure equality of treatment to State as well as to national banks.

(2) The loose provisions of the Aldrich-Vreeland Act allow any kind of securities, such as railway or other bonds, and any kind of paper held by national banks, as protection to the emergency notes issued through currency associations. But, in addition, the tax on these notes is so high that the rate charged to the borrower by a bank must be the result of panic conditions before they would possibly be asked for. With such a tax no resort is likely to be made to this act. Already the rate of interest (1912) has risen from 12 to 20 per cent and no appeal has been made to the law.

(3) The currency problem is one not merely of the issue of notes; it is closely connected with the organization of credit. To get a loan, with a consequent deposit-account on which checks can be drawn, is as effective a means of paying debts, according to the business and banking habits of this country, as the actual passage of bank-notes. Either notes or checking accounts should be equally available to the legitimate borrower, according to his needs, and the habits of our people. The elasticity of the two must go together. From whatever angle we approach the subject of banking, it will always

be found that soundness depends upon the kind of paper discounted. To secure soundness of discounts is the only real guaranty of safety to deposits.

Hence, apart from carefully guarding the paper rediscounted by the district associations, we must face the question of the security of note-issues, which pass into the hands of innocent holders and whose safety must be beyond question. To avoid the danger of the varying character of notes, due to the varying soundness of assets in banks of all kinds, the obvious remedy is the selection of one agency which should issue the notes needed by all the banks. The security of the notes issued by one agency would be so under the limelight that anything but safety would be impossible. Simplicity of issues, understood by all, would be a great advantage. If the supervising body over the district associations be chosen as the issuing agency, little machinery and no capital would be needed. Moreover, the notes would be the obligations of the combined district associations, but having a flexible margin of commercial paper which would make them entirely elastic, as well as entirely safe. Being redeemable in gold at any district association, they could not circulate in amount beyond the currency needs of the public. The important consideration to be borne in mind is that the safety and redemption of the notes are placed on the banks, without any cost for reserves to the United States. This agency, under the close supervision of the government, secures all the advantages of government issues, without any expense or inelasticity. And if there is anything in the claim that the national banks gain a double profit by issuing notes based on United States bonds, it is clear that this is taken away, and all the profits, both of issue and discount (beyond 5 per cent on capital), go to the United States.

The accounts of each district association would con-

tain the same items, and their combined figures reported to the treasury board would be published as totals every week. That is, the system of accounting at each district association would be identical; the combined weekly account would show the conditions for the whole country, and the accounts of each district association would afford means of comparison and a knowledge of methods followed in each section. By way of illustration, certain arbitrary figures are introduced herewith in a combined account in order to show in general the working of a system in which the note-issues are separated from the discounting operations.

Typical accounts:

I. OPENING OF BANK

District Associations

DISCOUNT

Dr.		*Cr.*	
Capital	$100,000,000	Cash reserves (national bank notes, lawful money)	$100,000,000
	$100,000,000		$100,000,000

Treasury Board

DEPARTMENT OF ISSUE

II. RECEIPT OF GOVERNMENT DEPOSITS

District Associations

DISCOUNT

Dr.		Cr.	
Capital	$100,000,000		
Government deposits	100,000,000		
		Cash (bank-notes or lawful money)	$100,000,000
		Lawful money	100,000,000
	$200,000,000		$200,000,000

Treasury Board

DEPARTMENT OF ISSUE

III. RECEIPT OF BANK RESERVES

District Associations

DISCOUNT

Dr.		Cr.	
Capital	$100,000,000		
Government deposits	100,000,000		
Bank reserves	400,000,000		
		Cash (bank-notes or lawful money)	$100,000,000
		Lawful money	100,000,000
		Lawful money	400,000,000
	$600,000,000		$600,000,000

Treasury Board

DEPARTMENT OF ISSUE

IV. READY FOR BUSINESS, DISCOUNTS TO BANKS

District Associations

DISCOUNT

Dr.		*Cr.*	
Capital	$100,000,000	Loans	$200,000,000
Government deposits	100,000,000	Cash (bank-notes and lawful money)	600,000,000
Bank reserves	400,000,000		
Bank-deposits	200,000,000		
	$800,000,000		$800,000,000

Treasury Board

DEPARTMENT OF ISSUE

V. ISSUE OF NOTES ON DEPOSIT OF LAWFUL MONEY AT ISSUE DEPARTMENT (Section 17)

District Associations

DISCOUNT

Dr.		*Cr.*	
Capital	$100,000,000	Loans	$200,000,000
Government deposits	100,000,000		
Bank reserves	400,000,000		
Bank-deposits	200,000,000	Cash (bank-notes and lawful money	400,000,000
		Treasury board notes	200,000,000
	$800,000,000		$800,000,000

Treasury Board

DEPARTMENT OF ISSUE

Dr.		*Cr.*	
Notes	$200,000,000		
		Lawful money	$200,000,000
	$200,000,000		$200,000,000

VI. ASSUMPTION OF BONDS FOR REDEMPTION OF NATIONAL BANK NOTES (Section 23)

District Associations

discount

Dr.		Cr.	
Capital	$100,000,000	Loans	$200,000,000
National bank notes	400,000,000	United States bonds	400,000,000 [320,000,000]
Government deposits	100,000,000		
Bank reserves	400,000,000	Cash (lawful money)	[80,000,000]
Bank-deposits	200,000,000	Treasury board notes	200,000,000
		Bank-notes and lawful money	400,000,000
	$1,200,000,000		$1,200,000,000

Treasury Board

department of issue

Dr.		Cr.	
Notes	$200,000,000	United States bonds	$ 80,000,000
		Lawful money	120,000,000
	$200,000,000		$200,000,000

The redemption of $400,000,000 of old national bank notes is assumed on the deposit of an equal amount of bonds. Then, later, $80,000,000 of these bonds are sent to the issue department in return for a like sum of lawful money.

The separation of the issue of notes from all other branches of business and the publication of separate statements of everything pertaining to them is a powerful safeguard against overissues and an important means of public education. Everybody, including the public, is thus kept fully informed regarding the aggregate volume and the fluctuations of such issues, the amount and frequency of redemption, and the state of the gold reserves; and such information will help to explain discount rates and other features of the business of the

VII. ISSUE OF NOTES BASED ON COMMERCIAL PAPER

District Associations

DISCOUNT

Dr.		Cr.	
Capital	$100,000,000	Loans	$140,000,000
National bank notes	400,000,000	United States bonds	320,000,000
Government deposits	100,000,000	Cash:	
Bank reserves	400,000,000	Treasury board notes	60,000,000
Bank-deposits	200,000,000	Treasury board notes	200,000,000
		Lawful money	80,000,000
		Bank-notes and lawful money	400,000,000
	$1,200,000,000		$1,200,000,000

Treasury Board

DEPARTMENT OF ISSUE

Dr.		Cr.	
Notes	$260,000,000	United States bonds	$ 80,000,000
		Commercial paper	60,000,000
		Lawful money of which $86,000,000 must be gold, *i. e.*, ⅓ of $260,000,000 notes	120,000,000
	$260,000,000		$260,000,000

From the assets (loans) of the district associations $60,000,000 were taken to the issue department in exchange for an equal sum of treasury board notes. This final account would represent the system in complete operation.

treasury board and the district associations in which the public will have interest.

§ 9. To dispose of the bonds held by national banks to secure circulation the following sections were introduced:

Sec. 23. National banks shall not emit any note issues beyond the amount outstanding on the day six months preceding the date of the passage of this act.

At any time within twelve months from the opening of said Treasury Board for business, each District Association may

receive at par from any qualified National Bank within its district the United States bonds, now bearing 2% interest, held by the Treasury for the security of National Bank notes, and in return said District Association shall assume the redemption of the national bank notes for which said bonds were pledged.

Sec. 24. The Secretary of the Treasury is hereby empowered, upon the application of the Treasury Board, to exchange at par three per centum securities, as hereafter described, for the two per centum bonds of the United States bearing the circulation privilege, which have been obtained through the respective District Associations from duly qualified banks, in the following manner: One-half of the amount of bonds thus presented for exchange at any one time shall be converted into three per centum bonds of the United States without the circulation privilege, payable permissably in five years and necessarily within twenty years from the date of issue; and one-half of the amount of bonds thus presented for exchange at any one time shall be converted into one-year notes of the United States, bearing three per centum interest, *Provided*, that the United States shall have the right to renew said one-year notes by due notice to said Treasury Board before maturity; or to pay them off in whole or in part at any time, provided further, that annual renewals shall not be made after twenty years.

The Treasury Board shall be permitted at any time, with the consent of the Secretary of the Treasury, to offer any part of its holdings of United States bonds or one-year notes thus refunded at sale for gold; *Provided*, that the United States reserves the right at any time to pay off any of such bonds or notes before maturity, or to purchase any of them at par for the trustees of the postal savings, or otherwise.

Sec. 25. The additional interest charge incurred by the United States Government as a result of the refunding of the two per cents into three per cents shall be paid by the District Associations out of their gross receipts in such a manner and at such times, not less than once a year, as shall be determined by the Treasury Board with the consent of the Secretary of the Treasury. Each Association shall pay such a portion of the total amount as its capital and surplus bear to the aggregate capital and surplus of all the Associations.

Sec. 26. All provisions of law requiring national banks to hold or to transfer and deliver to the Treasurer of the United States, bonds of the United States other than those required to secure outstanding circulating notes and Government deposits are hereby repealed.

§ 10. Reserves are disposed of as follows:

Sec. 27. The District Associations shall not pay interest on deposits.

Sec. 28. Each qualifying bank must conform to the following requirements as to reserves held against deposits:

First: If located in a town having a population of 6000 inhabitants or less, and having a paid-in and unimpaired capital of not over $50,000, each qualifying bank shall deposit in lawful money with its District Association five per centum of its demand deposits of whatsoever kind.

Second: If located in a town having a population of more than 6000 inhabitants, and having a paid-in and unimpaired capital of more than $50,000, each qualifying bank shall in its accounts distinguish between (1) bankers' balances, (2) individual demand deposits, and (3) time deposits.

Bankers' balances must be protected to the extent of 40 per centum, of which not less than 20 per centum shall be in lawful money; and of said 20 per centum, not less than 8 per centum must be deposited with its District Association; while the remainder of said 40 per centum (or 20 per centum) shall consist of commercial paper, as described in Section 8.

Individual demand deposits must be protected to the extent of 30 per centum, of which not less than 15 per centum shall be in lawful money; and of said 15 per centum, not less than 8 per centum must be deposited with its District Association, while the remainder of said 30 per centum (or 15 per centum) shall consist of commercial paper, as described in Section 8.

Time deposits payable in 30 days or less must be covered in the same manner as individual demand deposits; on other time deposits, 5 per centum reserves are to be kept.

Credit deposits with its District Association shall be counted by any qualified member bank as a part of its required reserves; but Treasury Board notes shall not be so counted.

The question of banking reserves is much simplified if a separation is made between (1) reserves for note-issues and (2) reserves for deposits. In the national banking system reserves are kept solely for deposits, because the notes are protected, not by reserves, but by government bonds and a 5 per cent redemption fund (although this same redemption fund can be counted as part of the reserves behind deposits). In the Monetary Commission Plan confusion is introduced by going back to our early defective banking system, in which one reserve was held against both notes and deposits. In any rational modern system the protection for the notes should be provided for quite independent of the rules for banking reserves behind deposits. On this assumption nothing further need be said as to the reserves for redeeming notes.

Deposits in commercial banks may arise either (1) from daily deposits of cash and checks by business firms, or (2) from a loan operation. The immediate and first result of a loan is the creation of a deposit-account to the credit of the borrower. Also, business concerns generally expect loans from a bank about in proportion to the amount of their average deposits. Consequently, in most commercial banks the total item of loans does not vary much from the total item of deposits; if loans are much below deposits, it shows conservative lending. Since deposits are chiefly the outcome of loans, or of deposits of checks drawn on other credit accounts, reserves are most closely connected with the borrowing or discounting at a bank. If loans are increased, there follows an increase of deposits, and hence an alteration in the percentage of reserves; and *vice versa*, if loans decline. Consequently, the question of reserves has to be considered chiefly in connection with the regional institutions vested with the power to make discounts.

Given a certain amount of demand-deposits, those in whose favor they stand may call for the use of their funds either (1) in the form of notes and cash, or (2) by drawing checks on their accounts. Which of these two forms will be resorted to depends upon the business habits and customs of the patrons of the bank. In large financial centres, and in most cities, large payments are made chiefly by checks; in rural districts, where men are at a distance from banks, notes are often needed to complete a cash sale; but even here checks on banks are fast being introduced. The point to be kept in mind is that banks must provide whichever means of payment is demanded by their customers.

The pivotal question, however, is the relation of reserves to the power of a bank to lend. If new loans are made, the demand-deposits are increased and the percentage of reserves to deposits is lowered. Under present conditions, the borrower who wishes cash (*e. g.*, to meet his pay-roll) will draw from lawful-money reserves, thus again lower the percentage of reserves, and cripple the immediate lending power of the banks. If, however, the district associations were empowered to exchange picked commercial paper for "treasury notes" at the offices of the treasury board, they could fill up their reserves whenever a legitimate demand for discounts arose from individual banks; and the individual banks could draw these notes from their accounts with the district associations whenever the public needed cash. Thus the individual banks would be protected from drains on their lawful-money reserves by being able to pay out "treasury notes" whenever the owner of a deposit-account might choose to want cash (instead of drawing checks on his deposit-account). In effect, there are two restraints on overexpansion in regard to notes: (1) the

surveillance over the commercial paper presented by individual banks to the district associations, accompanied by a rising scale of commissions, although the rate of discount is uniform in the district; and (2) another restraint in passing paper from the district association to the treasury board for notes. The individual member banks should not be allowed to count "treasury notes" as reserves, but should be obliged to aid in founding our monetary system throughout the country broadly on gold. If "treasury notes" were to be counted in reserves, there would be a premium on holding them, getting more, and not sending them in for redemption when issues were not called for by the public. If individual banks could count deposits with district associations as reserves, it would encourage deposits with other than central reserve city banks. It may not be logical to allow deposits to count as reserves, and not notes, but practical considerations should govern. If cash reserves are needed at home, individual banks can always get the notes redeemed in gold. Thus the contraction, as well as the expansion, of "treasury notes" is obtained, which fulfils the true meaning of elasticity of the currency.

Now we are in a position to discuss the idea that we must have a "centralization of reserves," in order to prevent the scattering of reserves (which is undoubtedly a great evil in times of alarm). It is implied that all the cash reserves must be under one control, *i. e.*, taken away from New York and placed in Washington. Why? In order that the reserves should be physically transferred from one place to another when needed? That is not credible. The whole question is one of mobilization of reserves (no matter where the exact spot of storage is) in order to make lending possible on picked commercial paper in time of stress. There is nothing to the reserve

question except its effect on lending. The so-called centralization of reserves is disposed of by any plan which enables discounts to be made in amounts as large as is consistent with safety and with the needs of legitimate borrowers.

The only real fear those have who demand some "centralization" is that otherwise no institution (*i. e.*, no district association) will have enough resources, or be big enough, to meet emergency demands and secure respect in Europe. This objection can be met by having fewer district associations and having each one larger; instead of twenty, have no more than ten. In Chicago, for instance, in 1912, one large bank should have been able at once to get $10,000,000 added to its reserves by rediscounting good paper. The $10,000,000 credited as a deposit to Bank X in Chicago as the result of the rediscounting would count as part of its reserve. That instantly touches its power to lend. Is this not the whole point at issue? Why is there a need of any further "centralization of reserves"? A bank can draw "treasury notes" from its deposit-account with the district association, if cash is wanted in the Northwest, or elsewhere. That, of course, would lower its lately increased reserve, but the plan is made for just that purpose—to enable notes to be paid out in time to meet crop-movements. And the bank can get more reserves in the same way, if there is a real need. But it is to be remembered here that the bank might not, as now, draw notes from the district association as just suggested: by the system of transfers allowed in this plan, the given bank could transmit a credit to any other bank-account with any other district association; that deposit-credit would count as reserves to the given individual bank; and the lending power of that bank would be directly affected in the interest of its local borrowers.

What more could be accomplished by so-called "centralization of reserves"? Are not some persons caught more by a phrase than by the essential thing to be attained?

§ 11. Next we may present the matter of earnings.

Sec. 35. The earnings of each District Association shall be disposed of in the following manner:

After the payment of all expenses and the reduction of losses, if there be any, the semi-annual earnings shall be distributed among the qualifying banks in proportion to the number of shares owned by each, except that earnings in excess of four per cent per annum of the total paid-up capital stock shall be distributed as follows: One-half of the excess shall be distributed among the qualifying banks and one-half be transferred to an account of the Government of the United States on the books of the Treasury Board, provided that the total amount of said surplus paid to the qualifying banks shall not exceed one per cent of the total paid-up capital stock, it being the intent of this act that all earnings in excess of five per cent of the total paid-up capital stock shall be credited to the account of the Government of the United States on the books of the Treasury Board.

After each dividend has been declared, all additional earnings shall be transferred to the account of the Government of the United States on the books of said Treasury Board, and shall be disposed of by said Treasury Board as follows, and in the following order of precedence:

(*a*) A sum equal to one-fourth of one per cent of the capital stock of each District Association shall be set apart annually for eight years, to form a contingent fund to meet any possible losses. In case of liquidation, this fund shall be credited to the account of the United States Treasury.

(*b*) A sum equal to one per cent of the capital stock shall be assigned annually to a surplus fund until such fund shall amount to 20 per cent of said capital.

(*c*) Of United States notes held in special reserve by the Department of Issue, as hereinbefore provided, a portion equal to the balance on the account of the Government of the United

States shall be returned to the Secretary of the Treasury for cancellation and destruction, the Government's account being debited with the amount thus returned; *Provided* that the maximum amount thus returned shall not exceed the amount of the total issue of such notes in excess of the $150,000,000 gold reserve held by the Secretary of the Treasury for their redemption. After all the United States notes in excess of said $150,000,000 gold reserve shall have been cancelled and destroyed in this manner, all additional holdings of such notes by the District Association and all such notes in any manner coming into the possession of the District Associations in the future shall be exchanged for gold at the Treasury of the United States, and the notes so exchanged shall be cancelled and destroyed; and all such notes thereafter coming in any manner into the possession of the Government of the United States shall in like manner be redeemed, cancelled and destroyed.

(*d*) Any such earnings as are not disposed of in the manner indicated in paragraphs (*a*), (*b*), and (*c*) shall be applied to the purchase at par from the District Associations or the Treasury Board of holdings of the three per cent refunded bonds hereinbefore described.

(*e*) After all such purposes mentioned in this section shall have been fulfilled, any surplus earnings of said District Association shall be paid into the account of the United States Treasury.

The provisions of Section 35 are based on two principles: (1) that the institutions created by this act should not be influenced in their operations by the desire, or the need, of earning large dividends for their stockholders; and (2) that any profits accruing to the United States Government from their operations should be used in the improvement of our currency and in the payment of the national debt.

What is needed is not an additional source of revenue for our banks and trust companies, but means for their more complete functioning, to the end that financial crises may be avoided and the agricultural, industrial,

and commercial interests of the country be better served. The treasury board and the district associations should be guided solely by considerations of the latter kind, and to this end this section limits the dividends that can be paid to stockholders to 5 per cent of their holdings of stock. It is believed that dividends of at least this amount will be earned without special effort on the part of the associations, and that such dividends will constitute sufficient financial remuneration to the banks and trust companies that join the association, their chief remuneration being the rediscount and other advantages which membership will bring.

It is more than likely that actual earnings will be greatly in excess of expenses plus 5 per cent of the capital stock. In this case means will be provided for ridding our currency of the United States notes which take the place in our currency of an equivalent amount of gold and impose upon the Treasury the dangerous obligation of maintaining a gold reserve. The requirement according to the provisions of this act will not occasion even a temporary contraction of the volume of the currency, since treasury notes will take their place as fast as they are withdrawn from circulation, and gold will take their place in the reserves of the district association when they are cancelled and retired. Neither will their retirement occasion any expense to the government; on the contrary, by these means a portion of the public debt will be paid off by profits derived from private business agencies.

After the retirement of the United States notes and the accumulation of adequate contingent and surplus funds, the use of surplus profits in the purchase of 3 per cents from the district associations is desirable, since the substitution of commercial paper and gold for bonds as cover-

ing for the treasury notes should be accomplished at the earliest possible moment, and while such substitution can be accomplished by the sale of the bonds on the open market, such sales may not happen to be in the interests of the Treasury at the time they ought to be made in the interests of the district associations and the currency.

This section must be considered in connection with Sections 17 and 18, which provide for the gradual retirement of the greenbacks, and the national bank notes. Under the operation of its provisions, these forms of currency would gradually accumulate in the reserves of the treasury board and notes of the board would take their place in the circulation of the country.

Sections 29–34 on investments are similar to Sections 32–36 and 38 of the National Monetary Commission Plan,[1] and need not be reproduced here. In Section 30 authority was granted to district associations to invest in the short-time paper of foreign governments. Such investments would have the special advantage of putting the district associations in a position to draw gold from abroad, either through collection at maturity or rediscounts on foreign markets.

§ 12. The old problem of correcting the evils of the independent treasury is taken up as follows:

Sec. 36. The Government of the United States shall upon the organization of the Treasury Board deposit its general funds in any of said District Associations, and thereafter all receipts of the Government, exclusive of trust funds, shall be deposited with said District Associations, and all disbursements by the Government shall be made through said District Associations.

[1] See Appendix II.

The elimination of the disturbances on the money market occasioned by the operations of our independent treasury system is one of the chief advantages to be attained by the establishment of the treasury board and district associations. The present section provides for the use of the district associations by the government as a place of deposit for all its cash except the trust funds.

The retention by the Treasury of these latter funds, consisting of the gold held for the redemption of the gold certificates, the $150,000,000 gold reserve held against the United States notes and the silver dollars held for the redemption of the silver certificates, is a matter of indifference to the money market, the volume of the currency not being in any way affected by them and the redemption operations based upon them. It is the locking up of funds in the Treasury when receipts exceed expenditures and their deposit and withdrawals from the depository banks at the option of the secretary of the treasury that causes the trouble which it is proposed to remove by making the district associations the depositories and disbursing agents of the government.

§ 13. Section 37 of this bill on foreign banking was the same as Section 57 of the plan of the National Monetary Commission, and need not be reprinted. (See Appendix II.)

This section has nothing to do directly with the district associations and might easily be included in a separate act. It is, however, not inappropriate to include it, since the district associations, by creating a market for commercial paper, will greatly increase our facilities for transacting foreign business, and thus make desirable the creation of the kind of institution for foreign banking here provided for.

The provisions of this section give the district associations full authority to replenish their gold reserves by negotiations on foreign markets if necessary. Such authority is necessary in the interests of safety and their proper management at all times.

To what extent the district associations would find it necessary or desirable to open offices in foreign countries is uncertain, but foreign connections in the form of accounts with foreign banks and agencies would be indispensable.

Authority to buy and sell foreign bills is justified on the same grounds as investments in the short-time paper of foreign governments. A portfolio of foreign bills would constitute the best reserve protection the district associations could have, since such bills could ordinarily be turned into gold at any time.

§ 14. Provision as follows was made for reports and examinations:

Sec. 38. Monthly balance sheets in the form prescribed by the Treasury Board, guaranteed as to correctness by their respective Boards of Directors, shall be supplied to the District Associations by all banks whose names appear on the paper offered for discount.

Balance sheets of firms and corporations whose paper is offered for discount, in the form prescribed by the Treasury Board, shall also on request of the District Association be furnished by the bank offering such paper for discount, and such balance sheets shall represent no asset at more than its actual value and no liability at less than its true amount.

The Treasury Board shall make a report showing the totals of the principal items of its balance sheet and of all the District Associations once a week. These reports shall be made public. In addition, full reports shall be made to the Comptroller of the Currency by said Treasury Board, coincident with the five reports called for each year from the national banks.

All reports of national bank examiners in regard to the condition of banks shall hereafter be made in duplicate and one copy filed at the office of the Treasury Board for the confidential use of its executive officers and District Associations.

The Manager of each District Association may call for reports of State bank examiners applying to State banks qualifying for rediscounts, and in case such reports are not for any reason supplied, the District Association shall have the power to make examination of such banks through its own officers.

The Secretary of the Treasury shall annually appoint a committee of five persons, at least three of whom shall be expert accountants, to make from time to time a careful examination of the conditions and business of the Treasury Board and the District Associations and to make at least once a year a public statement of the results of such examination.

The Treasury Board shall also annually appoint from among their number a committee of three persons to make at least once in three months a careful examination into the condition and business of the Board. This committee shall report to the Treasury Board.

The balance-sheet reports required from qualifying banks and from corporations, firms and individuals whose names appear on the paper offered for discount are important, not only because they will supply the data needed in the determination of the quality of such paper and the character and methods of business of the institutions presenting it, but because of the influence it will have on the conduct of business by the promotion of balance-sheet accounting. To compel business concerns frequently to prepare accurate balance-sheets will go far toward promoting sound and eliminating unsound operations.

The affairs of the treasury board and district associations must be given wide publicity, because its operations will constitute the money-market barometer of the country. Hence the requirement of the publication of weekly

balance-sheets. Every precaution should also be taken that their affairs are conducted in a proper manner. Hence the requirement of reports to the comptroller of the currency and of examinations by expert accountants and financiers and by committees of the directors.

§ 15. The next sections deal with the serious difficulties of clearings and collections:

Sec. 39. Whenever a District Association shall have received for collection checks and drafts drawn on institutions outside its own district, it shall send to each of the other District Associations those drawn upon institutions within the district of said Association with the aggregate amount of the checks and drafts so sent. It shall credit to the account of each Association the checks and drafts in like manner sent in for collection. At the close of each day's business each District Association shall send to the Treasury Board hereinafter described a statement of the amounts thus debited and credited, together with the balances due the other Associations or due by them to it, and in case the net balance is adverse, it shall accompany said statement with a check to the amount of said adverse balance drawn against its account with the Treasury Board. Each District Association shall keep with the Treasury Board a balance sufficient to cover such checks. The Treasury Board shall each day credit to the accounts of the District Associations having favorable balances the proceeds of the checks thus received.

The Pujo Committee raised a question as to great sums earned by city banks in collections of checks. The provisions of this bill cover all that matter, and provide for collections of checks with an advantage to all the banks, large or small. These advantages arise from the creation of district associations, superimposed on existing clearing-houses, as already described. The district associations will assume not only the discounting func-

tions of the clearing-houses (accompanied with the inhibition of clearing-house certificates), but also introduce an economy in the present system of collections.

This bill allows, of course, the system of transfers from one account to another on the books of any district association, which was contained in the plan of the Monetary Commission. This is, in effect, the well-known method of *giroverkehr* by the Reichsbank. The clearing of country items is not provided for by the German system; for checks drawn on deposits are little used in Germany. This bill goes further: it provides for needs created by the customs of our own country. It is made the duty of the district associations to further in every possible way the clearing of checks between banks in all parts of the country. The method is simple.

Nothing in this bill interferes with the offsetting of checks by the 137 clearing-houses within their respective cities. In each city, however, banks would sort checks into (1) city, or (2) outside items. The former would go to the city clearing-house, as now. The latter would go to the district association, and the course of proceedings would be as follows: Bank X, in Chicago, might present to its district association (in Chicago) items composed of checks on banks outside of Chicago, to, say, \$1,000,000. Immediately Bank X, a qualified bank, having an account at the district association, would be credited with the \$1,000,000, without the expense or delay of collecting checks all over the country (varying from two to ten days), and without the loss of interest thereby involved. These items are at once sorted by the Chicago district association into two classes: (1) those on banks within the territory of the Chicago district association, and (2) those on banks in other district associations. For (1), the checks would be debited to the ac-

counts of qualified banks on the books of the Chicago district association (since only checks of qualified banks would be handled). For (2) the checks would be sorted according to the district association in which the banks are situated, and each package sent immediately to its respective district association. On receipt by each district association the checks are charged to the accounts of the qualified banks in each district association. Since each qualified bank's account would be thus credited and debited on the books of its respective district association, only balances need be paid; and these balances would be paid by checks drawn on the district association, thus avoiding all needless movement of cash between both district associations and individual banks. The economy of this process would be very important. The expense of recording each item for verifying its progress would be considerable, and not to be overlooked. The present wasteful shipments of actual cash from large cities to distant parts of the country would cease. The cost of collections, about which so much complaint has been made, would be reduced. The large banks would have a cash credit immediately on deposit of outside items. Such a provision for the extension of the clearing-house function throughout the whole country (instead of being confined within any one city), through the district associations, directly under governmental supervision, would tend to remove all existing clearing-houses, which are unincorporated and voluntary associations. Thus whatever problems—if any—were raised by the Pujo Committee would be fully met by the provisions of this bill which puts under lawful control both the discounting and offsetting functions of existing clearing-houses. In this case, the law could be said to have overtaken the voluntary and extralegal operations of trade

and banking, the supervision of which is undertaken in the interest of equality to all, big or little.

It is to be observed, finally, that these provisions, for assuming and legalizing all the functions of clearing-houses—especially the inhibition of clearing-house certificates in time of panic—form the strongest possible reasons why all banks should qualify with their respective district associations. They could not afford to take the risk of staying out; while, if they come in, they gain positive advantages in collections as well as in reserves, and full opportunity for rediscounts without fear or favor.

It may not be desirable to force this system of collections and clearings at the outset; but to make it possible under the act and permit it to develop by a natural and gradual growth.

CHAPTER X

THE FEDERAL RESERVE ACT

§ 1. Out of all the efforts for reform in the past generation, and from the various proposals of different minds, there was actually passed in the Federal Reserve Act of 1913 the most comprehensive monetary and banking law ever placed on our statute-books in the whole history of the nation. It marks the culmination of our banking progress. Toward this result many events have contributed. It is an interesting story with a happy ending.

In order to be able to test the new legislation,[1] it will be interesting to summarize here the defects in our banking and currency system which were generally accepted at the beginning of the recent campaign (1910–1913): an inelastic bank-note circulation; an even more dangerously inelastic credit system; ineffective use of a large supply of gold; a scattering of reserves and lack of co-operative action by banks in times of stress; a rigid reserve system which induced panics; State banks and trust companies doing a commercial business but in different systems; an independent treasury divorced from the money market which imperilled bank reserves in times of difficulty; the drift of idle funds to the call-loan market where they fed stock speculation; and the want of American banking facilities in other countries to aid our foreign trade. It

[1] The original text of the act is given in the *First Annual Report of the Federal Reserve Board*, December 31, 1914, pp. 25–44, as well as in many other places. In amended form it can be obtained by any one on application to the Federal Reserve Board, Treasury Department, Washington, D. C.

will be fitting to watch as we go on whether these demands, which were formulated before the new law was even drawn up, have been effectively covered.

We may then proceed to an examination of the act of December 23, 1913. In order to secure clearness it may be best to discuss its provisions under some general heads, and under each head to include the history of the various proposals, as follows:

(1) Control and Organization
(2) The Federal Reserve Banks
(3) The Note-Issues
(4) Disposal of the 2 Per Cent Bonds
(5) Reserves
(6) The Organization of Credit
(7) Clearings
(8) A Discount Market
(9) Foreign Banking

§ 2. Around the question of organization and control centred the main antagonism to the plan[1] of the National Monetary Commission, which proposed a national reserve association as the means for centralizing reserves and thus preventing the admitted evil of the scattering of reserves existent under the old system. In this scheme an elaborate organization was built up, beginning with local associations of banks which elected directors for district institutions of which there were to be fifteen in the whole Union; these fifteen directorates were to elect a central governing body of forty-five, with an executive committee of nine, in power over the national reserve association, of which the fifteen institutions were to be branches. It is to be observed that the directors of the central body were to be chosen by the representatives

[1] See Appendix II for the plan.

of the banks. Such an institution was not, in the usual acceptance of the term, a central bank, because it would do no business with the general public. Nevertheless, having one central directing body elected by the banks, opposition was raised against it on the ground that effective control over it might be obtained by ambitious financial groups. This opposition appeared under the so-called "fear of Wall Street."[1]

In the original Glass Bill, proposed by the House committee, and given out unofficially June 17, 1913, there was proposed an entirely different system of organization and control. Instead of a national reserve association with fifteen branches, there was offered a decentralized organization of separate, incorporated, regional Reserve Banks, in as many districts, supervised by a Federal Reserve Board, having no capital and no banking functions.[2] Immediately attention was focussed upon the composition and powers of the Federal Reserve Board, since it was assumed that this board would have direction over the general banking operations of all the banks in the country, State or national, which might enter the new system. As to its composition, the original Glass Bill gave equal representation on the Federal Reserve Board to the lending bankers, the borrowing business public, and the government. A board of nine members was to

[1] In Congress it was emphatically stated that, irrespective of the merits of a central bank, it could not be proposed by Democrats, because it was forbidden by the Baltimore platform. *Cf.* p. 146. It is difficult to reconcile this position with that taken in favor of abolishing all preferences to American coasting-vessels going through the Panama Canal, which was in direct opposition to the platform of the Democratic party. The truth probably is that political advantage was gained by opposing a central bank. In addition, it may well be that regional banks were better suited to our conditions.

[2] Mr. Mann, the Republican leader in the House, said: "So far as we have been able to learn, the bill will be in the main pieces stolen from the Aldrich Monetary Commission Report, with a few radical provisions taken from the Bryan platform mixed in. It will be a jumble of discordant ideas." (June 23, 1913.)

be composed of (1) the secretary of the treasury, the secretary of agriculture, and the comptroller of the currency, *ex officio;* (2) three to be chosen by the President of the United States, of whom one would be designated as governor, etc.; and (3) three, presumably bankers, to be chosen by the Federal Reserve Banks.

When the bill prepared by the House committee came to be passed on by Democratic leaders, before it was adopted as an administration measure, the issue of control became prominent and drew great discussion. The administration demanded governmental control over the banking system, urging that bankers *per se* were the ones to be supervised, and, therefore, should not control the Federal Reserve Board (any more than railway men should control the Interstate Commerce Commission). Accordingly, the Glass Bill, before being presented to the Democratic caucus of the House, was modified by changing the number of the board from nine to seven, of whom the two cabinet officers and the comptroller were to be *ex officio* members, and four others were to be appointed by the President, of whom one (later changed to two) should be experienced in banking. The original bill provided only that the governor of the board could be removed by the President on a statement of the reasons; while in the changed bill the President was given power of removal for cause over the four members appointed by him for a term of ten years. On June 23, 1913, President Wilson read in person to the extra session of Congress his currency message, in which he said:

> The control of the system of banking and of issue which our new laws are to set up must be public, not private, must be vested in the government itself, so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative.

As opposed to this view the bankers held that they were obliged by the bill to enter the system, or lose their charters as national banks; that a portion of their capital was "commandeered" for the stock of the new organizations, over which they were refused any control; that such a forced contribution without representation was practical confiscation; that such an invasion of the government into the realm of private ownership was "socialistic"; and that, in the analogy of the Interstate Commission, the commission supervises, but does not pretend actually to operate, the railways, while the Federal Reserve Board is given direct control over banking operations. The American Bankers' Association, at Boston, October 8, 1913, opposed the compulsory contribution of capital without representation on the board as follows:

In return for the capital thus appropriated the banks receive a certificate, which cannot be sold, assigned, or hypothecated, over which none of the usual rights of property can be exercised. [National] banks are obliged to make this subscription, or be dissolved. Charters have ever been regarded in the nature of a contract, and it is doubtful if, under our Constitution, Congress can take away the charter of a bank in this summary manner, not because the terms of the charter have been violated by the banks, but because the bank management might refuse to make a coerced investment such as the pending measure provides.

. . . If the government can appropriate one-tenth of a bank's capital in the manner provided by this bill this year, it may appropriate one-tenth the next year, and so on until the capital is all transferred to the government bank. If it can fix the compensation at 5 per cent this year, it may make it 4 per cent next year, and 3 per cent, 2 per cent, 1 per cent—a very simple and easy process whereby the entire capital of the banks may be transferred to the government.

. . . This proposition of the government to take the banks' capital in the manner provided, carried to the extreme, would

easily accomplish, so far as the national banks are concerned, this contention on the part of the Socialists. For those who do not believe in Socialism it is very hard to accept and ratify this proposed action on the part of the government.

To the bankers political control by appointees of the President, without banking experience, meant incompetent management. Consequently, they urged that three members of the board should be elected by the directors of the Federal Reserve Banks.

Thus was the issue joined between government supervision and banking control. It is now obvious that the issue hinged on the powers granted to the Federal Reserve Board. If actual banking operations are carried on, not by the Reserve Board but by the directors of the respective Reserve Banks, a majority of whose directors are chosen by the member banks, the question at issue practically disappears. What, then, are these powers?

In Sec. 11 are enumerated the powers of the Federal Reserve Board:

(*a*) To examine, and require weekly statements of, reserve and member banks.

(*b*) To permit, or by a vote of five members to require, one Federal Reserve Bank to rediscount for another, and to fix the rate of discount charged in such a case.

(*c*) To suspend reserve requirements for not more than thirty days, provided a tax is imposed on Reserve Banks should reserves fall below a certain percentage.

(*d*) To supervise the issue and retirement of Federal Reserve notes.

(*e*) To add to, or reclassify, existing reserve or central reserve cities.

(*f*) To remove for cause any officer or director of any Reserve Bank.

(*g*) To require Reserve Banks to write off worthless assets.

(*h*) To suspend any Reserve Bank for violations of this act.

(*i*) To safeguard all collateral, notes, etc., deposited with its agents; and to make all rules necessary to enable the Board to perform the duties, functions, or services of this act.

(*j*) To exercise general supervision over Reserve Banks.

(*k*) To permit national banks to act as trustee, executor, etc., and establish rules therefor.

(*l*) To employ experts, assistants, clerks, etc., and fix their salaries and fees.

Besides the grant of these specific powers, additional powers[1] were granted in other sections throughout the act as follows:

1. To readjust Federal Reserve districts (sec. 2).
2. To regulate the establishment of branch banks within the respective Federal Reserve districts, and appoint three directors for each branch (sec. 3).
3. To designate three members (Class C) for each Federal Reserve Bank, one to be chairman of the board and known as the "Federal Reserve Agent"; and to secure impartial treatment to each member bank (sec. 4).
4. To call at discretion the unpaid half of capital stock; to determine the amounts returned to a bank withdrawing from membership (sec. 5); and to pass on the amount of any reduction of capital (sec. 28).
5. To pass on applications for membership from state banks, and to establish by-laws therefor; to prescribe rules enforcing requirements of this act (sec. 9).
6. To require a member bank to surrender its stock, if it fails to comply with the law or rules of the Board (sec. 9).
7. To levy on the Reserve Banks a semi-annual assessment to cover the expenses of the Board (sec. 10).
8. To have general supervision over the Bureau of the Comptroller of the Currency (sec. 10).
9. To make an annual report to the Speaker of the House of Representatives (sec. 10).
10. To approve salaries and allowances granted to members

[1] *Cf. Report of House Committee on Banking and Currency,* September 9, 1913, No. 69, Sixty-third Congress, 1st session, pp. 46–47.

of Advisory Council; and to call meetings of said Council (sec. 12).

11. To define the character of the paper eligible for rediscount by Reserve Banks; and to regulate discounts by said banks of bills receivable, bills of exchange, and acceptances (sec. 13).

12. To fix the percentage to the capital of a Reserve Bank which limits the discounts of agricultural paper having a maturity of not over six months (sec. 13).

13. To establish rules for dealings in cable transfers, acceptances, and bills of exchange, or in securities of the United States, or subdivisions thereof, by Reserve Banks (sec. 14).

14. To review rates of discount charged by Reserve Banks (sec. 14).

15. To pass on applications of Reserve Banks wishing to engage in foreign operations (sec. 14 (*e*)).

16. To issue at discretion Federal Reserve notes to Reserve Banks on deposit of an equal amount of collateral security; to call for additional security therefor; to assign a distinctive letter and serial number for notes issued by the respective Reserve Banks; to require each Reserve Bank to maintain at the United States Treasury a gold reserve (not less than 5 per cent) for its own notes; to grant or to reject any application for notes; to establish the rate of interest to be paid for such notes; to make rules allowing substitutions of collateral behind the notes; and to charge Reserve Banks with all expenses due to printing, issue, and retirement of such notes (sec. 16).

17. To fix charges for checks cleared through Reserve Banks and for transfer of funds among said banks (sec. 16).

18. To establish at its discretion a Clearing House for Reserve Banks, or one for member banks (sec. 16).

19. To require Reserve Banks to purchase United States bonds when member banks give them up to withdraw circulation, according to a given allotment (sec. 18).

20. To grant approval of refunding of 2 per cents into 3 per cents by the Secretary of the Treasury and Reserve Banks (sec. 18).

21. To permit a non-member to obtain discounts from a Reserve Bank through a member bank; to allow the reserve

of a member bank with its Reserve Bank to be drawn upon under penalties; and to allow national banks in Alaska and outside the continental United States (except the Philippines) to join a reserve district (sec. 19).

22. To examine member banks; to accept in some cases examinations of member banks by state authorities; to fix salaries of examiners (instead of the present fee system); to permit special examinations; to demand information from a Reserve Bank at any time regarding a member bank; to order an examination of each Reserve Bank at least once a year (sec. 21).

23. To add to the list of cities in which national banks are not permitted to loan on real estate (sec. 24).

24. To approve or reject applications of national banks to establish foreign branches, and to order examinations of said branches (sec. 25).

25. To force a national bank to cease to act as a reserve agent, if it did not enter the system within 60 days after the act was passed (sec. 2).

A study of these powers of the board shows that they are mainly supervisory or administrative after the general example of the powers of the comptroller of the currency over national banks. In a few respects, however, it may be said that the board has more than supervisory powers.

In Sec. 11 (*b*) and (*c*) the board is given power to require one Reserve Bank to discount for another, and to suspend reserve requirements (for member banks as well as Reserve Banks) for not more than thirty days. This latter power, to be sure, has been exercised in effect by the comptroller's discretion in not closing a bank whose reserves were below the legal limit. In making general definitions regarding eligible paper for discount (Sec. 13), the action of the board is still in the main supervisory. Moreover, it has only powers of review, not initiative, over the rate of discount set by the respective Reserve

Banks (Sec. 14). Also, the board may reject applications from Reserve Banks for notes, but probably this authority is only to be exercised in order to restrict unhealthy expansion, or because the collateral was undesirable, and the like. In regard to establishing a system of clearings (Sec. 16), however, the board has powers of initiative which are certainly more than merely supervisory, touching not only the earnings, but the existing methods of business of member banks. Also quite as important as any is the power to suspend any officer or director of any Reserve Bank (Sec. 11 (*f*)), which means obviously any director elected by the banks as well as its own appointees. Yet it is to be observed that in no case is the board empowered to conduct strictly banking operations of discount and deposit.

On the other hand, as distinctly opposed to the Federal Reserve Board, stand the Federal Reserve Banks, to whom are given all strictly banking functions of discount, deposit, and—in a practical sense—issue. While the bill was in the hands of the Senate committee an attempt was made, and supported by the Republican minority, to give direct banking powers to the Reserve Board, thus creating a type of central bank. Fortunately, this proposal failed. Consequently, the success of the new system must depend for its essential banking operations on the managements of the respective Reserve Banks.

As regards the general question of control, it is to be noted that there is a distinction to be made between governmental and political control. There may be governmental supervision and direction through the Reserve Board which is not political, provided the board is not governed by political motives in its action. Appointment of members of the board by the President should not mean political management any more than in the

case of the supervision exercised by the comptroller of the currency over national banks in the past; or any more than presidential appointment of judges means political decisions on the law. More than this, it is to be kept in mind that the control of discounts and deposits, the primary functions in a banking system, is placed in the hands of the boards of the respective Reserve Banks, the majority of whom are elected by member banks, and who should be men of practical banking experience. Thus, while there is governmental supervision by the Reserve Board, as above described, all questions of discounts and use of deposits, in the daily round of business, are left to technical bankers.

As to the possibility of changing the political character of the Reserve Board, let us assume that President Wilson were succeeded by a Republican on March 4, 1917. The board was being appointed in (say) April, 1914. Then the term of the member appointed for four years would expire in April, 1918; and of the one for six years, in April, 1920. Hence both of these positions, in addition to the appointment of the secretary of the treasury, might be filled by a new President. The term of office of the comptroller of the currency, appointed in 1914, being five years, his successor would be named by a new President. Thus a majority of the board (four out of seven) could be reconstituted in the term of the next President.

The co-ordinating influence of a supervisory board will go far to remedy the scattering of reserves formerly so great an evil; to establish continuity of policy; to gain co-operation between all the banks represented in the Reserve Banks; to check trouble in one district before it has extended to another; and, without the dreaded centralization, to have federation with local government in each district. Already concentration, without legal

regulation, had appeared, but it had not prevented scattering of reserves, nor an individualistic condition of banking (very far from the common control that had been so much feared). The legal creation of a central body which could have been captured and used would have been a very much more dangerous thing. Regional banks, each sovereign in its own district as regards discounts, have probably removed this danger forever. Moreover, the Federal Advisory Council, one member chosen respectively by each Reserve Bank, gives the board a nexus with conditions in all parts of the Union, and by the publicity of its opinions should exercise an influence proportionate to the soundness of its judgment.

§ 3. The legislative struggles gathered mainly about this question of central control. The nice point in the result was the right adjustment of the powers of the over-board as compared with those of the Reserve Banks. Here was the need of high legislative skill as well as of practical banking insight. The outcome is remarkable. It would have been easy to go too far in either direction. On the one hand, due to a current belief that a control over credits was possessed by the larger banks of New York City, there were many who regarded government control of banking credits as the only means for securing equality of treatment. This attitude was a part of the present-day tendency to press for increasing governmental interference with trade and industry. While there was opposition to a central bank of private capital and of private management, there was more or less support for a central bank owned and controlled by the government. Thus, although there was a well-preserved tradition in the Democratic ranks (based on ignorance of the real services of the Second United States Bank, and

which did them little credit) against a central bank, and although Democrats were supposed to dislike a centralization of political power, yet the opposition to the plan of the National Monetary Commission was clearly due, not so much to fear of a central bank, as to the fear of a privately capitalized central institution which might be controlled by the "interests."

On the other hand, sensible men of all parties realized that it would be impracticable to allow government officials, often political appointees, to do the actual work of technical banking, to grant loans, to manage resources and investments—in short, to introduce the government into the banking business. Political control was obviously as dangerous as private financial control; and it would have been destructively inefficient.

The solution of the matter finally adopted was, interestingly enough, centralization by districts; that is, a centralization intended to prevent scattering of reserves was obtained by establishing in each district an institution itself quite similar, in powers within its jurisdiction, to the national reserve association of the Monetary Commission. That is, the government was saved from going into the banking business by granting local centralization with capital and management supplied by the banks, and yet federated under a common authority in order to establish governmental direction and unity of purpose. In its essence this plan retained the workings of local self-government, together with the operation of technical banking by those who supplied the capital, but under general direction. This final adjustment which secured safe and efficient methods, as contrasted with the chaotic proposals which might have been adopted, should be a cause of permanent congratulation. The nice balancing of powers between governmental super-

vision and technical banking also appears in not going too far in local decentralization as illustrated in the development of our clearing-house operations. In these, because of the absence of any legal aids, local clearing-houses had been granting efficient banking service in times of panic, but in an isolated, unco-operative manner. Detachment went to extremes; each clearing-house was working without efficiency, because working by itself.

It is to be observed, moreover, that the solution adapted to our conditions, in which a widely scattered system of individual banks had to be retained, must be original with us. In no other country were the conditions the same. The relation of a central bank in European states to other banks was not one based on the existence of a system of individualistic and numerous banks carrying on independent operations. Therefore, while retaining self-management of privately owned banks, co-operation was obtained by Reserve Banks in local districts under management by bankers, while country-wide and uniform action was gained by governmental direction through a Federal Reserve Board.

The difficulty of sectional differences of interest working against each other would, nevertheless, have to be met in the practical workings of any plan. If there had been one central institution, pressure would have been brought upon the central management to help out one section of the country at the expense of another. Under a system of regional banks, each section gets the support of its own resources first of all, an arrangement by which sectional antagonism is reduced to the minimum. In addition, when one section is in trouble beyond its own powers of recovery, then by aid of the Reserve Board, one Reserve Bank may come to the aid of another. Such a practice, it is to be noted, had been going on in

an extralegal way in previous years whenever the banks of a large centre sought assistance from New York. Such a practice was natural and inevitable. In the new law such practice is openly recognized and legalized. It is, in effect, the same kind of action asked for by one borough, whose protective equipment has been taxed to excess by fire when it seeks the aid of another borough, not so threatened.

A Federal Reserve Bank is to be established in each of at least eight, and in not more than twelve, districts, "apportioned with due regard to the convenience and the customary course of business" in the continental United States, excluding Alaska (Sec. 2). This was to be done by the organization committee, who have since agreed on twelve. Not only existing business and transportation relations must be considered, but also the nature of the industries, in order that all the resources of a district should not be invested in only one kind of paper presented at the same time. Obviously delimitations of districts may seem geographically curious, but yet be industrially correct.

Each Reserve Bank will perform all the general functions of a typical bank, and its powers may briefly be enumerated as follows:

1. To incorporate, have succession for 20 years, and sue and be sued (sec. 4).
2. To appoint its own employees (sec. 4).
3. To have all the special powers granted in this act, and all those incidental to carrying on its business of banking (sec. 4).
4. To have a capital of not less than $4,000,000 (sec. 2).
5. To establish branches in its district, and designate four of the seven branch directors (sec. 3).
6. To pay dividends on stock, if earned (sec. 7).
7. To determine the relative amount of credit granted to each bank (sec. 4).

8. To obtain circulating notes after the manner of national banks in the interim before Reserve notes supersede national bank notes (secs. 4, 18).

9. To provide compensation for directors (sec. 4).

10. To be exempt from taxation (sec. 7).

11. To elect a member of the Advisory Council (sec. 12).

12. To pass on all discounts allowed by this act to member banks (sec. 13).

13. To fix the rate of discount to member banks (sec. 14).

14. To receive deposits from the Treasury or member banks, if it keeps 35 per cent reserves in gold or lawful money (secs. 13, 16).

15. To hold deposits from, and open accounts with, other Reserve Banks for exchange purposes (secs. 13, 14).

16. To buy and sell in the open market bankers' acceptances and bills (sec. 14).

17. To deal in gold coin at home and abroad; to borrow gold on security of government bonds, etc. (sec. 14).

18. To buy and sell at home and abroad government securities, bills, notes, revenue warrants, etc. (sec. 14).

19. To maintain agencies, correspondents, and banking accounts abroad for dealings in bills of exchange (sec. 14).

20. To receive government deposits, and act as fiscal agent for the United States (sec. 15).

21. To present commercial collateral and obtain Federal Reserve Notes, if it holds a 40 per cent reserve in gold for them (sec. 16).

22. To receive at par checks on member banks (sec. 16).

23. To become a clearing-house for its district (sec. 16).

24. To join in purchasing not over $25,000,000 per annum of United States bonds securing circulation, in allotments designated by the Reserve Board (sec. 18).

25. To have 2 per cent bonds refunded into 3 per cents (sec. 18).

26. To examine member banks and their foreign branches (sec. 21).

From this exposition it will be seen that each Federal Reserve Bank is to perform all the fundamental banking functions of issue, discount, and deposit; but that it is

a bank for banks, and, with some exceptions to be noted later, not a bank for the public. Viewed from the standpoint of correcting existing evils in our banking and currency system, it will be found, from our later discussion, that the Federal Reserve Banks are established for the purpose of providing (1) through the issue-function an elastic currency; (2) through the discount-function the much-needed elasticity of credit by a reorganization of our credit structure; and (3) through the deposit-function an effective mobilization of bank reserves to secure co-operation in times of stress; and (4) the abolition of the antiquated independent treasury system. More than that, a possibility of an extension of the clearings-functions seems to open up.

These facts disclose clearly that the Reserve Banks form the backbone of the whole system, and that its success will depend directly upon their management. Here is the crux of the whole matter. Upon the directors of these banks lies the heaviest responsibility arising from the new law. It is very much to be doubted if legislators or the public realize the practical difficulty of finding the men competent to assume this responsibility, and of insuring a sound, intelligent, skilled, and judicious management. Consequently, the methods of choosing the directors and officials are of first importance. The nine directors of each Reserve Bank have a term of three years, and are divided into three classes, A, B, and C (Sec. 4). The three members of Class A are supposedly to be bankers, and are chosen by the member banks of the district. The directors of each member bank choose one elector; from the total list of persons nominated, one by each bank, the electors are to choose the three directors of Class A. At the same time and by the same electors, three directors for Class B are to be chosen in

the same way, who shall be men actively engaged in commerce, agriculture, or industry within the district. The Reserve Board appoints the three members of Class C, who shall have been residents of the district for at least two years, and one of whom shall be designated as chairman of the board of directors and also as the "Federal Reserve Agent." In short, the constituent banks have the power to choose more than a majority (six) of the nine directors of each Reserve Bank, while the representative of the Reserve Board is always present. By this arrangement, technical banking operations are relegated to the Reserve Banks, and the responsibility for good or bad management is placed on the banks themselves, on the men whom they have elected. In choosing the directors of Classes A and B, the member banks are to be divided into three general groups; "each group shall contain as nearly as may be one-third of the aggregate number of the member banks of the district and shall consist, as nearly as may be, of banks of similar capitalization" (Sec. 4).[1]

Much discussion was also had on the most desirable number of Reserve Banks. Irrespective of banking considerations, to politicians it was of course imperative to have one in each congressional "deestrict." To believers in a central bank, it was supposed that a small number, like four, could be made to work like one. The desire for decentralization, however, forced a larger number. But it was a mistake to fix upon any definite number at the outset. It would have been better to have started with the three central reserve cities (New York, Chicago, and St. Louis), having "regard to the convenience and

[1] Section 4 was amended June 21, 1917, and September 26, 1918. The division of groups into one-third the aggregate number was dropped, and the procedure of election simplified.

customary course of business," and to have given the Reserve Board power to increase the number of districts as time and experience demanded. In the working of the law as it stands, we shall probably have another illustration of the impossibility of legislation to change materially the natural tendencies of trade. The Reserve Bank in New York City will be the largest and most influential because the banking capital and trade of New York City is, and will remain, the largest. In times of stress other parts of the country will continue to some extent to go to New York or Chicago for help, solely because it is the place where help can be had. Yet, apart from these considerations, it should not be forgotten that the mere size of the capital of a bank is no measure of its lending power. In neither men nor banks is size a warrant of virtue. The quality of its management, the amount of its deposits, the character of its discounts are all of more importance to the efficiency of a Reserve Bank than the amount of its capital.

So marked a departure from our past banking institutions and practices as is involved in the new law is certain to encounter obstacles. The very existence of discounts, and earnings thereon, in a Reserve Bank depends upon the rediscounting of paper received in the course of business by member banks who wish to get assistance from a Reserve Bank; and yet rediscounting has been generally regarded in this country as suspicious, or as an evidence of weakness. The practical underhanded devices by which the need, indicated by rediscounting, has been actually met in the past would be wholly unnecessary under the new act. Obviously, if banks of high standing and strength have recourse, as they undoubtedly will, to rediscounting paper at a Reserve Bank, any small bank can do the same without casting suspicion

upon its condition. What is normal and usual will cease to excite comment. But since rediscounting has been resorted to in the past only when it was desired to strengthen a bank's reserves, it has been held by some experienced bankers that recourse to the Reserve Banks for rediscounts will be had only in times of stringency, and that in normal conditions of trade the Reserve Banks will do little business.[1]

In anticipation of inactive funds, provision has been made to allow the Reserve Banks to engage in certain open-market operations. It is understood, of course, that it was expected these banks would discount only for member banks, and not for the public (except as later explained). The power to invest idle funds permits dealings at home or abroad in bonds and notes of the United States, and bills, notes, revenue bonds, and warrants maturing in not over six months to anticipate revenues of any State or other division of the United States, or of irrigation, drainage, or reclamation districts (Sec. 14). Such dealings are to be carried on under rules of the Reserve Board, but the power is wide. Under "bills" is included, no doubt, "bills receivable," as mentioned in the section preceding (Sec. 13). Such bills, as well as domestic bills of exchange, acceptances authorized by this act, cable transfers, bankers' acceptances, and bills of exchange "of the kinds and maturities by this act made eligible for rediscount, with or without the indorsement of a member bank" may be bought and sold "either from or to domestic or foreign banks, firms, corporations, or individuals" by a Reserve Bank (Sec.

[1] Any hesitation as to rediscounting was entirely overcome during the European War. In fact, the Federal Reserve Banks were pushed to the limit in carrying our government loans. So far did it go that the system could no longer be regarded as a recourse in any additional emergency. *Cf.* Chapter XI, § 9.

14). Here we have a surprisingly large departure from the limitation of business to member banks. It seems to suggest large possibilities of dealings with the public, if the paper is in the form of bills of exchange, etc. It is much to be doubted if the effect of these provisions has been fully foreseen.

As regards dealing in public securities, or foreign bills of exchange, there can be little question; but it is to be noted that dealings in the securities of foreign governments are not included. It was urged in behalf of a central bank that it was necessary to the maintenance of a sufficient fund of gold; and the experience of the Bank of France was an obvious example of what might be done. It is to be determined whether twelve Reserve Banks can preserve our gold supply as well as one central institution, or as it was done through New York in the past voluntarily. Very much can, of course, be done to regulate the international flow of gold by skilful dealings in foreign exchange; but here we may have no unified action. On the other hand, we are a gold-producing country; and the Reserve Banks can start with strong gold reserves behind their liabilities. Yet, apart from expected movements of gold on a considerable scale, we must face the possibility of a great and unexpected emergency. It is well known that in the past we have had no official institution capable of negotiating for gold with the great European banks. Will a separate Reserve Bank be regarded as satisfactory? Perhaps the New York Reserve Bank will be the one large enough to be relied on. However that may be, each Reserve Bank is given specific power "to deal in gold coin and bullion at home or abroad" and "to contract for loans of gold coin or bullion, giving therefor, when necessary, acceptable security, including the hypothecation of United States

bonds or other securities which Federal Reserve banks are authorized to hold" (Sec. 14). Here will come in the suitability of the one-year 3 per cent notes not having the circulation privilege given in exchange for 2 per cent bonds having the circulation privilege (Sec. 18).

§ 4. Apart from the effect of the Federal Reserve Act of 1913 on our credit system, its relations to our currency system will have special interest to the general public, notably to those who have been concerned with the struggles over government issues and free silver. For a long time this country had been facing a decision on the question whether the forms of money (irrespective of the standard, be it gold or silver) needed as media of exchange in the daily round of business should be issued by the government, after the example of the United States notes (*i. e.*, greenbacks), or by the banks, after the example of national bank notes.[1] In order to determine the bearing of the new law on this general question, a statement of the provisions regarding note-issues will first be given.

No change is made in regard to any of the following forms of money: gold, gold certificates, silver, silver certificates, and United States notes. Indeed, all past questions touching the standard were definitely settled by a remarkable amendment in the House, now embodied in Sec. 26 of the new act, which emphasized the maintenance of the gold standard:

> Nothing in this Act contained shall be construed to repeal the parity provision or provisions contained in an Act approved March fourteenth, nineteen hundred, entitled "An Act to define and fix the standard of value, to maintain the parity of all forms of money issued or coined by the United States, to re-

[1] *Cf.* the author's analysis in *Money and Prices* (1919), chap. X.

fund the public debt, and for other purposes," and the Secretary of the Treasury may, for the purpose of maintaining such parity and to strengthen the gold reserve, borrow gold on the security of United States bonds authorized by section two of the Act last referred to or for one-year gold notes bearing interest at a rate of not to exceed three per centum per annum, or sell the same if necessary to obtain gold.

Thus it was the act of 1913 rather than the act of 1900 that practically established the gold standard.[1]

Likewise, the only provision affecting the greenbacks is that (Sec. 7) which devotes the net earnings from Reserve Banks accruing to the United States "to supplement the gold reserve held against outstanding United States notes," or to reduce the bonded indebtedness, at the discretion of the secretary of the treasury.[2]

The direct purpose of the new act is to replace the national bank notes, within a period of twenty years or more, by Federal Reserve notes. These notes are described as follows (Sec. 16):

Federal reserve notes, to be issued at the discretion of the Federal Reserve Board *for the purpose of making advances* to the Federal reserve banks through the Federal reserve agents as hereinafter set forth and for no other purpose, are hereby authorized. The said notes shall be *obligations of the United States* and shall be receivable by all national and member banks and Federal reserve banks and for all taxes, customs, and other public dues. They shall be *redeemed in gold on demand at the Treasury Department* of the United States, in the City of Washington, District of Columbia, or in gold or lawful money at any Federal reserve bank.

These notes can be obtained only by a Federal Reserve Bank, on the deposit of an equal amount of commercial paper as defined by Sec. 13. Each note issued shall carry

[1] *Cf. supra*, pp. 3, 11.

[2] Amended March 2, 1919.

on its face the distinctive letter and serial number of the Reserve Bank putting it out, thus making each Reserve Bank responsible for the redemption of its own issues. That is, instead of United States bonds, as in the case of national bank notes, the ultimate security behind the Federal Reserve notes is to be commercial paper; in addition these notes are also "a first and paramount lien on all the assets" of the issuing Reserve Bank. The Federal Reserve Board, through its federal reserve agent in each Reserve Bank, may charge the latter a rate of interest on these notes, at its option; and the board has the right, if it so chooses, to refuse entirely any application for notes. The comptroller of the currency shall provide the plates and dies, have a supply of notes ready for each bank, and charge all expenses to such banks. There is no limit to the total amount of such notes; and there is no tax when issues pass beyond a certain sum, except the possible charge of a rate of interest, as just mentioned. In effect, the supply of these notes is directly related to the supply of rediscounted commercial paper, although the whole of any rediscount is not, by any means, likely to be paid out in notes. So much for the methods of issuing these notes.

As regards the contraction of the notes when not needed, redemption is provided for by gold reserves of 40 per cent against notes outstanding. No Reserve Bank shall pay out the notes of any other Reserve Bank under a penalty of 10 per cent; but it is obliged to present such notes for credit or redemption to the bank that issued them. Likewise, Federal Reserve notes presented at the Treasury are redeemed out of a gold fund left with the Treasury by the Reserve Banks which shall not be less than 5 per cent (but counting as part of the 40 per cent reserve); and the Treasury will remit any notes thus

redeemed to the respective Reserve Bank for reimbursement. A Reserve Bank, although required to hold reserves of 40 per cent in gold against its outstanding notes, may redeem them either in gold or lawful money. When a Reserve Bank wishes to reduce its liability for Federal Reserve notes, even if its own notes are not obtainable, it may deposit with the federal reserve agent any Federal Reserve notes, gold, gold certificates, or lawful money. By these provisions, it is obvious that contraction of notes, not needed by the public, is fully provided for. In short, elasticity of note-issues—expansion in time of need and contraction when the need has passed—is fully provided. Furthermore, there can be no possible question as to their safety, secured as they are, first, by a gold reserve of 40 per cent; second, by the pledge of picked commercial paper to the par value of the notes; third, by a first lien on all the assets of the Reserve Bank; and, finally, by the guaranty of the United States—an obligation not likely ever to be called upon, in view of the prior protection.

The language of the act (in Sec. 16) relating to Federal Reserve notes is equivocal. It is an obvious attempt to satisfy those who believe in government issues of paper money; while at the same time it is not the purpose seriously to impair the real functions of the issues as bank-notes. Thus the final outcome of the time-honored dispute, so far as reached by this act, seems to be in essence and in practical operation a settlement in favor of bank-notes; for the Federal Reserve notes are in no real sense government issues. The Treasury has no power to issue them in payment of governmental expenses; since the initiative must come from the Reserve Banks, and only on the offer of commercial paper originating in a private business transaction. Although not so stated

literally, the notes are liabilities of the Reserve Banks, since they must redeem them, and since the notes are a first lien on all the assets of such banks. To state that the notes are the obligations of the United States and may be redeemed at the Treasury is only "a frill," of no practical import; since it is unlikely that the government would ever be called upon to meet this obligation. To say that, in issuing the notes, the Treasury is "making advances" to the Federal Reserve Banks is meaningless (and, if it serves a political purpose, no harm is done); since the action of the board in passing out notes in return for a pledge of commercial paper is as purely administrative as the present action of the comptroller in handing over printed national bank notes in return for a pledge of United States bonds. Nothing in the words of the act can be construed as making these notes government issues, any more than national bank notes are government issues.[1] On this outcome, and on the escape from serious monetary error, the country is to be congratulated.

The law looks forward to a new basis for the bank-note circulation which has been formerly based on United States bonds. These notes are eventually to be displaced with Federal Reserve notes based on commercial paper. This displacement, involving the disposal of \$740,000,000 of United States bonds now used to secure circulation, will be treated later.

A national bank entering the new system is not, however, obliged to give up its present circulation; and the withdrawal of national bank notes by existing national banks is tied up with the disposal of the bonds to which

[1] It is not worth while to give attention to the claim that Federal Reserve notes are "fiat money," on the ground that, being government obligations, the government makes no provision for their redemption. Other provisions remove them from this imputation.

the circulation privilege is already attached. Nor are national banks obliged to present their bonds for exchange into others having no circulation privilege under Sec. 18, unless they choose. Consequently, the displacement of existing national bank notes by Federal Reserve notes will be long deferred. If it were possible to dispose of the bonds amounting to $740,000,000 to the full satisfaction of the banks, how could an equal amount of Federal Reserve notes be issued to take their place? Since the latter were to be secured only by commercial paper, instead of bonds, it follows that there would have been a considerable contraction of bank-notes, unless the Reserve Banks had prime discounted paper on hand to at least $740,000,000. Obviously, this sum could not be counted on; and a contraction of the currency would not have been politically wise. Hence the provisions of the House bill, allowing a more or less rapid substitution of Reserve notes for national bank notes, were dropped by the Senate. Of course, under the new act, quite independently of the national bank circulation secured by bonds, Federal Reserve notes may be issued at any time to any amount according to the provisions of Sec. 16. If issued, they would be an addition to the existing national bank circulation; and the security behind them would be commercial paper, not bonds.[1]

If, however, national banks prefer to sell their bonds they may do so, after December 23, 1915, and within a period of twenty years thereafter, in limited amounts each year (Sec. 18). The bonds thus disposed of by the banks are to be taken over by the Federal Reserve Banks; and the latter are then to be allowed to take out national bank notes on depositing these bonds with the comptroller, in the same way as national banks did; although

[1] See act of June 21, 1917, and Chapter XI, § 8.

they are not obliged to do so.[1] To the extent that Federal Reserve Banks should not take out notes on the bonds they have acquired there would be a contraction of the national bank circulation. But it is planned to prevent any considerable contraction of the national bank circulation, even if the national banks dispose of their bonds (*cf.* Sec. 4, Eighth). The final disposal of these bonds by the Federal Reserve Banks will be discussed later.

Understanding that the national bank circulation is not likely to be much reduced for the present, while the Reserve Banks may at any time add to the existing monetary supply, are we to expect, so far as notes are concerned, an undesirable expansion? By expansion must be meant the tendency to grant loans, through the too great ease of issuing notes or granting credits, without due regard to the soundness of the transaction giving rise to commercial assets. So long as loans are carefully restricted to safe loans based on an actual exchange of goods no swelling of liabilities occurs which must be finally reduced by forced liquidation. That is, undue expansion has its origin in excessive, or unsound, loans. An extension of bank-notes, then, can cause expansion only so far as it aids in an expansion of loans. If so, how will the note-issues under the new act work?

An increase in bank-notes can be used for two general purposes: (1) to satisfy the need of a medium of exchange in the hands of the public; or, (2) to supply bank reserves. In the former case, if pocket-money and till-money is already sufficiently supplied, then, unless the monetary

[1] If these notes are issued to Federal Reserve Banks under the same conditions as to national banks, the former must pay the tax of ¼ of 1 per cent, if the bonds pay only 2 per cent; but in Sec. 7 the former are free from federal taxation. *Cf.* Conway and Patterson, *The Operation of the New Bank Act*, pp. 138–139.

customs of the people have changed, no more bank-notes will remain in circulation, provided they are redeemable in gold or lawful money. In the latter case, the Federal Reserve notes cannot be kept as reserves by member banks. But, it is said, they may be presented, the same day they are obtained on a loan, for gold and lawful money by which reserves could be enlarged. On the contrary, if a member bank wished to increase its reserves by a rediscount, it would not need to draw notes at all, but would leave the proceeds of the loan to its credit at the Reserve Bank, in which form it is *ipso facto* added to its reserve account. There still remains, however, the possibility of getting Federal Reserve notes and exchanging them for lawful money at a non-member bank which can use Federal Reserve notes as reserves.[1] There would, however, be no more reason for this action than for the one just mentioned, since it would be less trouble to leave the proceeds of a loan at a Federal Reserve Bank on deposit where it would count as reserve. For these general reasons, then, there does not seem to be any ground for apprehension that the Federal Reserve notes will, if based only on commercial paper, be so put into circulation as to cause expansion. If any such expansion is intended, it can be more easily accomplished, without the use of the notes, through loans, deposit-accounts, and checks.

There are those, however, who measure expansion by the increase of prices. They probably hold that an addition to the circulation, according to the quantity-theory of prices, would raise prices; also, that an extension of loans, without the use of bank-notes, would stimulate credit and raise prices.[2] Redemption, on the other

[1] *Cf.* Conway and Patterson, *op. cit.*, p. 152.

[2] *Cf.* O. M. W. Sprague, "The Federal Reserve Act of 1913," *Quarterly Journal of Economics*, February, 1914, p. 240.

hand, would always force a test of the solvency of the transaction on which the credit is based; thus credit is kept wholesome and normal, so long as unsound loans are prevented.[1] A possibility of undue inflation is suggested, it may be mentioned, by such a reduction of reserve requirements as would weaken the certainty of redemption; but this consideration could not apply to the Federal Reserve notes, under this act.

§ 5. The removal of a bank circulation secured by United States bonds having been determined upon by general consent, a practicable and just disposal of the $740,000,000 bonds has not been easily found. The largest part of these bonds yield only 2 per cent; solely as an investment they would sell below 70; but, since they have the "circulation privilege" (or right to serve as security for national bank notes), the demand for them by national banks in the past has kept them above par, some having sold even as high as 110. When the new bill appeared, the national banks were directly concerned with the possibility of losses on their bonds, if the circulation privilege were withdrawn from them. In the proposed law the treatment of these bonds was the problem least well thought out.

When the Glass Bill became known, June 18, 1913, it contained sections then numbered 18, 19, and 20. Sec. 18 provided that no national bank should issue notes in excess of the amount outstanding at the passage of the act; Sec. 19 repealed the former acts requiring banks to hold bonds to the amount of one-fourth of their capital (if less than $150,000); and Sec. 20 required the secretary

[1] "The security against the consequences of inflation is not to be found in the limitation or extinction of notes, but in specie redemption for all liabilities, and in the encouragement given sound banking by steady oversight and publicity" (C. F. Dunbar, *Economic Essays*, p. 185).

on application to exchange the 2 per cent bonds having the circulation privilege for 3 per cents not having this privilege (but payable twenty years from date and exempt from all taxation) to an amount each year not exceeding 5 per cent of the total quantity of bonds held by the Treasury, while, as fast as the 2s were refunded, "the power of national banks to issue circulating notes secured by United States bonds shall cease and terminate"; and at the end of twenty years all the 2s should be exchanged for 3s, and all national bank notes should be recalled and redeemed.

To most politicians the note question is of primary importance; indeed, to allow banks under any circumstances to issue notes is to grant the "money-power" a privilege. Conferences of leaders were held. Senator Owen, chairman of the Senate committee, demanded the omission of Secs. 18, 19, and 20 in order that the question might be left to future legislation; and he gained his point. Then, on the representation of a committee of the American Bankers' Association, these sections of the bill were reinserted; and on June 26, 1913, the bill including them was introduced into the House and Senate.

As these sections stood, the 2s could not be sold in the future to secure circulation, since no more national bank notes could be issued than were outstanding at the passage of the act; and the only outlet would be their exchange for 3s. On June 28 the financial columns of the press noted a decline in the price of the 2s to par. At the best they could not sell higher than the 3s into which they were to be exchanged; and European states were not able to borrow at par at 3 per cent. Just at that time a tendency of the interest rate on permanent investments toward a higher level showed itself. It

might be that within the term of twenty years the 3s might not be worth par, it was said; thus, somehow, the belief spread that on the passage of the act the circulation privilege would be practically taken away. But, whatever the reason, timid holders of the 2s began to throw them on the market; hence, as the demand was small, a very few offers were sufficient to send down the price, and during July they were quoted at 95.

United States bonds (including 2s) had also been used to secure government deposits with the banks (some $50,000,000). If by the new act government deposits were to be transferred to the Federal Reserve Banks, then the demand for 2s (or any other United States bonds) as a security for deposits would to that extent be diminished.

This embarrassing situation[1] brought out a statement from Washington about the middle of July that Sec. 20 would be so modified as to allow all banks to take out circulation on the 2s as long as they were not exchanged for 3s; that the exchange of 2s into 3s would be permissive; and that at the end of twenty years the holder of 2s would receive par and accrued interest in cash. In effect, the circulation privilege was to be restored. It was also stated that Sec. 18 had been left in the bill by error; and when the bill was presented to the House caucus August 15, Sec. 18 had been omitted. More-

[1] As a consequence of the fall in the prices of the 2s, Secretary McAdoo on July 28, 1913, made the following statement to the public:

"The 2 per cent bonds are worth par, notwithstanding their decline in the New York market, a decline due not to any impairment of their intrinsic value, but almost wholly to what appears to be a campaign waged with every indication of concerted action on the part of a number of influential New York city banks to cause apprehension and uneasiness about these bonds, in order to help them in their efforts to defeat the currency bill."

The banks retorted that it was unlikely they would try to impair the value of their own assets amounting to $740,000,000. On the other hand, the statement might have retained radical support in Congress for a bill supposed to be antagonized by the large banks.

over, at this time (July 31) Secretary McAdoo announced he would deposit $25,000,000 to $50,000,000 of government funds with the banks of the South and West to relieve any autumnal stringency. To get these deposits banks must have outstanding at least 40 per cent of their authorized circulation, and if they pledged government bonds these would count as par against deposits. To that extent the demand for United States bonds would be increased and their price be raised.[1]

Finally, in the later stages of this legislation, the present provisions regarding bonds were inserted in Sec. 18 of the new act. After December 23, 1915, and for twenty years thereafter, any member bank wishing to retire its circulation may offer its bonds at par to the Treasury of the United States; at the end of each quarter, the Federal Reserve Board may require each Federal Reserve Bank to purchase a certain proportion of the bonds offered. The Reserve Banks may then take out notes, under the same conditions as national bank notes, equal in amount to the bonds they have purchased. If they do this, there will be no contraction of notes secured by bonds.

It is expected, however, that Federal Reserve Banks will not present to the comptroller all their bonds as security for notes; since any Reserve Bank may have its 2 per cent bonds against which no circulation is outstanding refunded, one-half into thirty-year 3 per cent gold bonds without the circulation privilege, and one-half into one-year gold notes of the United States bearing

[1] Furthermore, State and municipal bonds, etc., other than bonds of the United States, would be accepted at a valuation of only 75 per cent, and prime commercial paper at 65 per cent. This was the first time commercial assets were ever permitted under the act of March 4, 1907 (Sec. 3) to be used as security for government deposits. Since the passage of the present act, it has no further importance, except that it went far beyond the action of Secretary Shaw, so much criticised in his time.

3 per cent interest, without the circulation privilege. Thus, instead of the 2s, it may have long-term 3 per cent bonds which it can sell in the open market, and one-year notes which will be highly useful in borrowing gold in any foreign market. To the extent that Federal Reserve Banks refund their bonds the national bank circulation will be reduced; but at no time will the bonds held by member banks lose their circulation privilege, and after two years from the passage of the act they can be sold at par in amounts of not more than $25,000,000 in any one year. It follows, therefore, that not all the bonds can be disposed of in twenty years.

§ 6. The lending power of a bank, whether the loan is carried through by notes or by a deposit-account given to the borrower, is influenced by the regulations affecting reserves, which are the cash means for meeting demand-liabilities. On this important feature, it should be noted that the plan of the National Monetary Commission made no changes in the old system of reserves. Under the old national banking system, country banks were obliged to hold 15 per cent reserves in lawful money against deposits, of which 9 per cent could be kept with banks in reserve or central reserve cities; the banks in the forty-seven reserve cities were obliged to hold reserves of 25 per cent, of which 12½ per cent could be kept with banks in central reserve cities; while banks in the three central reserve cities had to maintain reserves of 25 per cent. Moreover, the required redemption fund of 5 per cent of outstanding circulation could be counted toward reserves for deposits. This redepositing of reserves in trade centres arose for business reasons: customers of local banks needed drafts, or exchange, on cities where they purchased goods; and such banks had

to keep funds there on which to draw. That is, redepositing of reserves was due to the need of exchange. Whether there were reserve laws or not, funds would have converged where the most goods were bought and sold. Some centralization of cash in this way was normal and inevitable.

By selling exchange on large city banks a local bank creates demand-liabilities at a distance; yet it has demand-liabilities in its deposit-accounts at home. The two things are different and lead to much confusion of mind. The sum kept with a city correspondent to cover exchange is really only a checking account, and in no sense a real reserve in cash that can be called for on demand; it is constantly being wiped out and replenished by miscellaneous items. But under the delusion that these funds are reserves (strengthened by the fact that the law permits them to be called legal reserves), local banks seem to think they can call on them in time of stress; then, of course, they cannot get the cash, and are highly indignant. In truth, checking accounts to cover exchange are not real banking reserves. This consideration should be kept in mind in studying the effect of the reduction of the percentage for reserves in the new act.

For demand-deposits, in the new law, a country bank was required to maintain reserves of 12 per cent; three years after the establishment of the Federal Reserve Banks, 4 per cent must be kept at home, 5 per cent in the Federal Reserve Bank, and the remaining 3 per cent, either at home or with the Reserve Bank at the option of the country bank.[1] That is, after three years, no funds left with city correspondents could be counted as legal

[1] In the transition period of three years the country bank must keep 5 per cent at home; in the Federal Reserve Bank for the first twelve months 2 per cent; and for each succeeding six months an additional 1 per cent, until 5 per cent was reached.

reserves. In short, funds to cover exchange, so long as it was drawn on city correspondents, must be carried independently of legal reserves. On the other hand, if exchange is drawn in the future on the Federal Reserve Banks, or branches (instead of on other banks), funds counted as reserves will still be used to cover exchange. Therefore, the reduction in the minimum requirement from 15 to 12 per cent reserve is more nominal than real.

A reserve city bank, in the new act, is required to maintain reserves of 15 per cent of its demand-deposits; after three years, 5 per cent shall be kept at home, 6 per cent in its Federal Reserve Bank, and the remaining 4 per cent either at home or with the Reserve Bank at option.[1] As with country banks, no deposits in other banks will then count as legal reserves.

A central reserve city bank was required to hold reserves of 18 per cent against its demand-deposits, of which, from the beginning, 6 per cent must be kept in its own vaults, 7 per cent in its Federal Reserve Bank, and the remaining 5 per cent either at home or with its Reserve Bank at its option.

Inasmuch as items passing from a depositing bank to its reserve agent should not be counted as reserves until collected, they should not be included by the reserve agent as deposits on which reserves are to be computed. The new act, therefore, enacted (Sec. 20) that "in estimating the reserves required by this Act, the net balance of amounts due to and from other banks shall be taken as the basis for ascertaining the deposits against which reserves shall be determined. Balances in Reserve Banks

[1] In the transition period of three years such a bank must keep 6 per cent at home; in the Federal Reserve Bank for the first twelve months 3 per cent; and for each succeeding six months an additional 1 per cent, until 6 per cent was reached. For changes before the transition period expired, in all three classes, see Chapter XI, § 2.

due to member banks shall, to the extent herein provided, be counted as reserves."

For all these classes of banks a new distinction is introduced between demand and time deposits: demand-deposits comprise all those payable within thirty days, and time-deposits all those payable after thirty days, including savings-accounts, etc., subject to thirty days' notice. Any bank is required, in addition to the above requirements for demand-deposits, to hold only 5 per cent reserves against time-deposits. As nearly as can be estimated, about one-third of the deposits of country banks are time-deposits; of reserve city banks, about 8 per cent; of central reserve city banks, about 1 per cent. Taking into account both the reduction of reserves against demand-deposits, and that due to the low rate on time-deposits, the nominal reserves (irrespective of redepositing) have been lowered in the new law by more than one-third, as may be seen from Table I, based on the reports of the condition of national banks, March 4, 1914:

TABLE I

[In millions]

March 4, 1914	Net deposits	Total time-certificates	Total savings-deposits	Total time-deposits	Required reserves under old system	Required reserves under new system	Reserves released under new act
Country banks	$3,761	$485	$777	$1,262	$564	$363	$201
Reserve city banks.......	1,970	59	93	152	492	280	212
Central reserve city banks...	1,773	15	1	16	443	317	126
Totals......	$7,504	$559	$871	$1,430	$1,499	$960	$593

Although the nominal reserves, especially of country banks, have thus been lowered, there remains the problem of the effect on the banks and on business of the transfer

of reserves, if any, from the reserve city banks to the Federal Reserve Banks. As to the sums which must be at once moved to comply with the law, the computations[1] which have been made show clearly that the cash holdings of the various classes of banks are more than sufficient to cover the transfers of the reserves, the payment of the required 3 per cent on the capital subscription of 6 per cent upon capital and surplus, and to retain enough reserves in their own vaults to meet the requirements of the act. That is, it would not be necessary for banks to call upon their reserve agents to cover the initial payments to the Federal Reserve Banks; but it is assumed that one-half of the reserves to be first paid into the Federal Reserve Banks could be obtained (as permitted in Sec. 20) by deposit of eligible commercial paper (as described in Sec. 13). In short, these figures present the minimum transfers in initiating the new system.

In viewing the effect of the transfer of funds on business loans, it is to be noted that, of course, the whole of the amount deposited by local banks in reserve city banks is not needed merely to cover exchange. As is well known, the payment of 2 per cent interest on deposits

[1] *Cf.* W. A. Scott, "Banking Reserves Under the Federal Reserve Act," *Journal of Political Economy*, April, 1914.

[In millions]

January 13, 1914	Country banks	Reserve city banks	Central reserve city banks
Total cash holdings	$284.0	$286.6	$429.2
One-half deposit of reserves	37.4	28.6	55.3
3 per cent subscription to capital	29.8	13.4	10.4
Reserves required at home	186.9	114.4	94.8
Balance of cash holdings	29.7	112.2	268.5

See also the figures of Conway and Patterson, *op. cit.*, pp. 251–252, 259, 267–269, 272, 275–276, 299, 301, 306.

by reserve agents attracts funds when idle at home; and a large deposit-account with its city correspondent gives the local bank corresponding advantages of treatment. In the report of same date the figures were as given in Table II.

TABLE II

[In millions]

March 4, 1914	Cash and 5 per cent redemption fund	Deposits with reserve agents
Country banks	$291	$551
Reserve city banks	261	286
Central reserve city banks	449	——
	$1,001	$837

The total net deposits of national banks subject to reserve requirements at that date were $7,504,000,000. Thus the actual cash of $1,001,000,000 was only 13.3 per cent of deposits; since the $837,000,000 of deposits with reserve agents was not cash. Hence the demand of member banks upon their reserves in the reserve cities, if made, for transferrence to Federal Reserve Banks would really fall upon the $1,001,000,000 of cash actually held in the present system.

The important consideration, however, lies in the effect on the lending power of the banks after and because of these transfers. With the balances left over in their reserves, could they still care for their customers? That question is obviously the one which forced the banks to be cautious with loans until the adjustment was finally completed. There are, however, two matters which might relieve any possible tension. In the first place, the above computation has not called for withdrawals from reserve city banks. It is well to be on the safe side in this matter; for the reserves with reserve city banks could not

be called upon to any extent in cash, since they are themselves the basis of loans made by the city banks. But, in the second place, the most important and effective method of taking care of the needs of customers in the transition period, and the one which would keep credits flexible, would be the rediscounting of short-time paper by member banks at the Federal Reserve Banks. The immediate effect of such a rediscount would be an increase of the reserves of the member bank, so long as the proceeds of the rediscount were left with the Federal Reserve Bank.

In addition, the use of government deposits in this transitional period would be a very important element. The deposits of the United States then held by national banks was about $58,000,000; while the other funds of the Treasury would allow the deposit of a much larger sum with the banks. Instead of placing large amounts with Federal Reserve Banks at the outset, it might be wise to aid the member banks by additional deposits.

As a counterweight to this possible restriction on loans, it should be kept in mind that the deposits of funds with city correspondents to cover exchange would no longer be so necessary, if instead exchange were drawn on the Federal Reserve Banks where funds existed to cover such drafts. To be sure, the payment of 2 per cent interest on deposits with the city banks, and the tendency to continue long-established relations with these agents, would work to retain the old exchange methods and to keep funds with city correspondents.

The general effect of the changes in the reserve system seem, on their face, to make easier an expansion of credit. That is, less cash reserves need to be carried; but member banks would have no reason for carrying as high reserves as in the past, if they hold short-time

paper such as they can use in getting discounts from the Federal Reserve Banks. And yet, in the transitional period, we are likely to see more or less caution and restriction of credit. That is, at the start, the tendencies toward expansion and restriction very nearly balance each other.

As concerns the reserves of the Federal Reserve Banks, as distinct from member banks, there is a requirement of a 35 per cent reserve against deposits to be kept in gold or lawful money; and against outstanding Federal Reserve notes a reserve of 40 per cent in gold. Any reserve requirements specified in this act, however, may be suspended for thirty days (and later for fifteen days at a time) provided a graduated tax is imposed on the deficiencies. Further it is enacted (Sec. 11 (*c*)):

That when the gold reserve held against Federal reserve notes falls below forty per centum, the Federal Reserve Board shall establish a graduated tax of not more than one per centum per annum upon such deficiency until the reserve falls to thirty-two and one-half per centum, and when said reserve falls below thirty-two and one-half per centum, a tax at the rate increasingly of not less than one and one-half per centum per annum upon each two and one-half per centum or fraction thereof that such reserve falls below thirty-two and one-half per centum. The tax shall be paid by the reserve bank, but the reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board.

Under the provisions of the act, a Federal Reserve Bank might carry no gold at all behind its deposits, and only the 40 per cent of gold behind its notes; since even then it could redeem its notes in lawful money. Thus the gold reserve beyond the 40 per cent behind notes is, in effect, available for either of the two demand-liabilities, deposits or notes.

§ 7. The Federal Reserve Act of 1913 undoubtedly opens for this country an entirely new epoch in the operations of credit and currency. Possibly because the developments in credit and in the mechanism of exchange have produced momentous changes in the last fifty or seventy-five years, it is safe to say that an act which should fully meet the conditions of to-day must be more important than any previous banking statute, not excepting the National Banking Act of 1864, or the act of 1791 establishing the first United States Bank. Certainly no previous measure has attempted to strike directly at the long-recognized rigidity of our credit system, which has itself led to unnecessary paroxysms of trade in the past, and which has also brought to light the underlying weaknesses of our currency system. For, wider and deeper than the inelasticity of our circulation has been the inelasticity of our credit system. And yet, until this act, practically the whole attention of reformers had been directed to creating an elastic note system. In the work of the Indianapolis Monetary Commission of 1898 this was eminently true.

So far-reaching a measure as this demands comparison with the great enactments of other countries, especially with the English Bank Act of 1844. That law was passed to meet a situation not unlike our own: gold redemption had been secured since 1821; crises had been disagreeably destructive; it was desired to have a note-circulation which would act like gold; as with us now, the use of checks drawn upon deposit-accounts had been growing; but it was generally believed that all difficulties were traceable to the note-issues. Then came the act of 1844, which set the notes off by themselves in the issue department; while the deposit and discount functions were relegated solely to the banking department.

With what result? That the operations of credit, independent of the note-issues, could, through the banking department, provide the most effective of all media of exchange (the deposit-currency); they could expand with trade; they could develop overtrading and crises; they could produce all the results formerly charged solely to note-issues. The unintended lessons of the Bank Act of 1844 are the most important in our monetary literature. Although the act represented the doctrines of the currency school, its actual operations were the triumph of the banking principle.

So with our act of 1913: while to many the matter of chief importance has seemed to be the note-issues, the real heart of the measure is to be found in the purely banking functions of discount and deposit. Not only are these pivotal, but they dominate the whole question of the note-issues. In our own country the struggles associated with the greenbacks and silver have centred attention on the circulation and the quantity of it in use. They have influenced the attitude toward bank-notes by leading some politicians, as before noted, to think that the issue of notes by banks would enable these banks to control the "money market" and the credit operations of the country. Moreover, the last previous act (the so-called Aldrich-Vreeland Act of 1908), intended to protect the country against possible panics, was based throughout on the assumption that credit emergencies could be met by an issue of national bank notes through currency associations. Yet in the serious emergencies in the autumns of 1912 and 1913, no resort was made to the act of 1908. Nevertheless, so firmly intrenched in the minds of our public men was the belief in the issue of notes to relieve a crisis that in the law of 1913 the act of 1908 was extended for another year; and the secretary

of the treasury assured the country that the act would be resorted to if necessary.

As the result of our exposition in preceding chapters, we may at the risk of repetition summarize the truth as to notes and deposits. When a loan is made by a bank it creates a demand-liability in favor of the borrower that can be met either by its own notes (or cash from its reserves) or by a deposit-account. Whether notes, or checks drawn on deposit-accounts, are used by the borrower depends on the kind of transaction, or on the business habits of the community where he wishes to make a payment. The elasticity so much extolled may be demanded in two different cases. In the first place, the seasonal demand for currency in the autumn had exposed the inelasticity of both our note and credit systems. It gave strong support to those who think our troubles centre in the currency. Why? Because in the past the demand both for strengthening reserves and for paying customers has been a demand for some form of money. Hence the emphasis on the need of an elastic currency; and so far as this need of actual currency exists it is of course imperative. But this is only a part of the truth, and not the most important part of it.

In the second place, the demand which comes in time of a panic brings us to the very core of the matter. Here, although to many minds even panic conditions are supposed to demand treatment in the form of additional issues of notes, the real need is for elasticity of credit. Where we have the deposit-currency well developed (as in the United States and Great Britain), there is no lack of a medium of exchange. Even in the worst of the crisis, if a borrower can obtain a loan, he has no difficulty in getting a medium of exchange. Consequently, the need of actual money is then of importance primarily as it

affects the reserves of banks and their lending power. Of course, a bank's own notes cannot be used in its reserves. Hence the real need is to stop the drain on cash reserves, or to obtain that by which reserves can be replenished. How can this be done? And how does the new act afford help at this point?

In the past, the National Banking Act caused rigidity of credit through its regulations touching not only its note-circulation but also its reserves; and most of all by the absence of all provisions for converting good commercial paper into a means of payment—whether the borrower calls for notes or uses a deposit-account. That is, the system was so constructed that when customers were in the most trouble and most needed help—when bank reserves were being drawn down—the bank was obliged to refuse new loans, to contract existing loans, to sell any available assets it had for cash, and to try to increase the ratio of its reserves to its demand-liabilities. Under the new act, just the reverse will be true. In times of distress there will be no need of contracting credit; in fact, the only time when it may be necessary to contract credit will be to check possible expansion during a tendency to overtrade (which will be discussed later). So far as borrowers, or the public, need forms of money in exchanging goods, or for various other needs, Federal Reserve notes can be obtained so long as banks holding good commercial paper demand such money. Therefore, irrespective of the elastic deposit-currency, there will be no inelasticity of a medium of exchange for the public; it can be had as needed, at any time.

But how does the act touch the reserves and the rediscounts so that it may bring about the much-desired elasticity of credit? This is the nerve-centre of the whole act. The pivotal provisions are those which allow

any member bank to have certain kinds of short-time paper rediscounted at its Federal Reserve Bank. At this institution the loan creates in favor of the borrowing bank a deposit-account. Then the pith of the operation resides in the fact that all sums kept on deposit at a Reserve Bank count as legal reserves for the given member bank. That is, the rigidity of credit-banking in the past, the destructive snatching for reserves, are displaced by a system which allows good commercial paper—under certain limitations—to be converted into lawful reserves. This is the process which directly touches the lending power of a member bank to its customers. Therefore, in a time of panic—if any such arrives—there will be no reason for a run on cash reserves, or, if there is a semblance of it, there will be a quick and ready way by which the reserves can be replenished. There can be no serious run on the cash by the public, because the member bank can furnish at will reserve notes, by making request for them at the Reserve Bank and having them charged against its deposit-account there. But it must still be kept in mind that banks deal primarily in credit, and only incidentally in money. Goods, when sold, and which form the basis of commercial paper, are thereby coined into a means of payment, and give rise to their own medium of exchange without necessarily calling on any forms of money. And yet the elasticity of the notes and of credit are, as they should be, linked together. In short, both notes and deposits (on which checks can be drawn) respond directly to the volume of commercial loans; and these loans are directly related to the general volume of goods bought and sold. Thus, automatically the amount of notes and the deposits adjust themselves to the needs of trade, since either can be had at the choice of customers. This outcome is one which no system of notes

directly issued by a government could possibly bring about.

The kind of paper made acceptable for rediscount under the decree of the Federal Reserve Board is all-important (Sec. 13). The essential point in the law is the distinction between mercantile and investment paper. It was not intended that the paper presented for rediscount should have been drawn to carry stocks, bonds, etc., or goods in warehouse held for higher prices; nor to aid in securing capital for fixed investment in irrigation, water-power, street-railway, manufacturing plant, or similar purposes. On the other hand, it was intended to encourage loans based directly or indirectly on the movement of goods from the producer to the consumer. Granting this general distinction, there remains the task of stating just what kind of paper in common use conforms to the spirit of the act.

About thirty years ago a change took place in our forms of paper. Previously, buyers of goods gave the sellers their notes for the allowed term of credit in payment for the goods, and these notes, usually indorsed by the seller, were discounted at the banks. This was, strictly speaking, "two-name commercial paper." Under this practice, in case of goods subsidiary to further manufacturing processes (like ore, pig iron, steel, and rails) there might be several notes in the hands of the banks covering substantially the same goods at different stages of manufacture. This usage has to-day practically disappeared.

The introduction of trade discounts[1] made it more profitable for the buyer to borrow at his bank and pay cash for his goods. Borrowers in good standing could thus pay cash; while only those of poor credit created

[1] This has been fully described *supra*, in Chapter IV, § 6.

"commercial paper." That is, the one-name promissory notes of borrowers in good standing at the banks were the best paper offered; yet it was not directly based on the sale of goods. The advantage of this method was that in effect it put trade on a cash basis. This development, moreover, seems to be peculiar to this country.

On the other hand, the modern practice has the disadvantage that it is not easy to know whether the borrower uses the proceeds of his loan to pay for goods, or whether he may use it for investment purposes; or in some form that is not liquid. Moreover, the acceptable borrower, once given a certain line of credit, usually keeps up to his limit by renewals, or continuous loans, without periodically clearing up his account by paying off his loans.

In addition it should be made clear that, besides the notes thus described, a concern may obtain large loans through the agency of note-brokers, who sell them to banks. These are the direct, unsecured obligations of the borrowers. The business of the note-broker has increased phenomenally with the growth of the trade discount. If a borrower cannot obtain cash to take advantage of the trade discounts, with the aid of the note-brokers, his standing is obviously low.

The Federal Reserve Board, therefore, not being able to alter business habits at once, must try to establish rules which would admit the highest grade one-name promissory notes, but would demand evidence that the loan was not used for investment, but for strictly mercantile purposes. The discounting bank must be held responsible for such evidence. In this way, the spirit of the act will be recognized, although the paper is not "strictly commercial." Yet there will certainly arise a tendency to devise forms of paper, which, while consis-

tent with the existence of trade discounts, will disclose more distinctly than the present promissory note the purpose of the borrower to use the loan for mercantile, and no other, purpose.

Such being the provisions of the new act regarding elasticity of credit, are there any dangers of expansion? Fortunately the essential functions of discount are not hemmed in by detailed legislative prohibitions; fortunately, one must say, because discounting must always remain a matter of judgment, and much must be left to the management. Yet, on the other hand, this very freedom from restraint might result, under unwise management, in inflation and danger. This is inherent in the very nature of banking; since under any system, good or bad, everything depends upon the kinds of loans made. And, of course, the coming of war or exceptional emergencies cannot be foretold.

Even with this new act, it is not to be supposed that we shall never see any more crises. Crises are more or less inevitable, because an act of Congress cannot prevent human optimism from overtrading in goods. Thus no matter how perfect is the machinery of our credit system, it will register the spasms of trade. The essential point to be gained by a desirable system of credit is that it should not aggravate the inevitable disturbances which will arise in emergencies of business; in the past, our rigid laws magnified any departure from regular conditions. In Europe, the banking systems are such as to minimize, and not magnify, trouble; which is the reason why Europe in recent times has been free from destructive panics, while this country has abounded in them.

The elasticity of credit implies both expansion and contraction according to the needs of business. Since any loan may be carried through by a bank giving either

its own notes (or other cash) or a deposit-account, expansion may be effected either by an overissue of notes or by an excessive creation of deposit-accounts. In some quarters, it is assumed that expansion can be regulated by regulating the issue of notes, or by taxing them, or the like. This is not true to the extent supposed. As a medium of exchange in paying wages, for travelling expenses, and for retail transactions, a certain sum of notes is always needed; but amounts beyond that will normally return to the banks. If the notes could be used as reserves, they would enable banks to expand loans. But Federal Reserve notes cannot be used as reserves by member banks; and here is a check on undue expansion. The danger, however, may exist elsewhere; these notes, like present national bank notes, could be used by the 17,000 or more State institutions in their reserves. So much, for present purposes, as to expansion through the notes (which are not limited in amount).

Those loans, it should be noted, which result in deposit-accounts at Federal Reserve Banks (and which are not drawn down by requests for notes) directly increase the reserves of member banks until transferred by check. Thus the lending power of the member bank is more quickly and extensively enlarged by this process than by the issue of notes. Herein lies the pivotal question of overexpansion. Passing by the question of overexpansion through the issue of notes, it is desired mainly to study here that arising only from the use of deposit-accounts and checks, because these operations are less understood and are more elusive. Here the possibility of expansion is even greater than in connection with notes, because the proceeds of a loan at a Reserve Bank, if left there, at once count as reserves, and permit another increase of loans.

To this possibility of serious expansion, what are the practical checks to be found in the bill? They may briefly be listed as follows:

1. Against notes the Reserve Bank must carry 40 per cent gold reserves; and against deposits 35 per cent reserves in gold or lawful money. But expansion will first develop in the member banks. They are not required to keep as large reserves as before against deposits (carrying, of course, no reserves for notes). They can make more profit with the same reserves by carrying more loans. Thus, there is no restriction here, except that of refusal of loans by the Reserve Bank.

2. In Europe the real control over expansion is in the rate of discount charged to the borrower. So must it be here, if it is raised early and not after the expansion has arrived; but watch must be kept on the particular bank beginning to expand its loans, and the treatment must be individually applied at the source. (See Sec. 5 of Proposed Bill, p. 172.)

3. A still more important check resides in the provision (sec. 13) that Reserve Banks shall rediscount only "notes, drafts, and bills of exchange arising out of actual commercial transactions," having a maturity of not over 90 days; although a limited amount of live-stock paper may have a maturity not exceeding six months. The final definition of all such paper is left to the Reserve Board. But loans secured by investment security cannot be rediscounted except in the case of United States securities. The spirit of the act, as already explained, forbids loans for such purposes as carrying goods in storage for a higher price, and should confine loans to paper based on goods actually sold. Just how to define such paper lays a heavy responsibility on the Federal Board. On it will finally depend the kind of assets allowed to Reserve Banks. (See *infra*, pp. 279 ff.)

4. A real restriction exists in making rediscounts on only short-time paper; but 90 days is somewhat too long for the best liquidity of assets. It was asserted, however, that country banks would gain no advantage by the new system, because they had little or no short-time paper. By the call of the Comptroller, August 9, 1913, it was disclosed that the reporting national banks held loans of $3,427,055,157 maturing in

90 days, and $2,594,351,440 maturing in a longer period; or 58 per cent of the former, and 42 per cent of the latter. The 6,736 country banks (outside central reserve and reserve cities) held $1,735,000,000 loans having a maturity of 90 days or less, and $1,337,000,000 maturing over 90 days. That is, even country banks hold more short-time than long-time paper. There is obviously enough paper to allow of expansion, so far as quantity goes. The real check must be in passing on the quality of the paper.

5. The exclusion of investment paper should cut off all possibility of expansion by stock-exchange speculation through the help of rediscounts at Reserve Banks. It is to be remembered, however, that any member bank can still loan on stock-exchange collateral to the extent that it does not wish for rediscounts; and that all state institutions not members can loan on such collateral. We have not, therefore, seen the end of stock speculation.

6. Rediscounts at the Reserve Banks must be indorsed by the borrowing bank. Hence there will be some check here.

7. Also, no member bank may loan more than 10 per cent of its capital and surplus to any one person or firm. This was later amended. (*Cf.* p. 279, *n.* 2.)

8. A real check is found in the restriction of discounts on acceptances in the original act to those based on importation or exportation of goods; and even these shall not exceed one-half the paid-up capital and surplus of the borrowing member bank. The original omission of domestic acceptances was a serious handicap to the desired discount market, but for a while it worked toward a restriction of potential expansion.

9. In practice the paper must pass rigid scrutiny in more than one step. First, it must satisfy the member bank; second, it must be satisfactory to the Reserve Bank; and, thirdly, if notes are wanted, it must pass the judgment of the Agent of the Reserve Board.

10. The power of the Reserve Board to examine into the operations of reserve banks, and the frequent or special examinations of member banks, will give an important control over expansion, or unsound banking, if legitimately used (secs. 21, 22).

11. Again, it is to be noted that, in rediscounting, a large number of individual banks will be related to each other in

a co-operative fashion. Something of an institutional character has been introduced, and it is possible to place responsibility here and there as was never possible before. This development should gradually and by experience prove of importance in controlling overexpansion.

12. Finally, if fear arises from the absence of any limit on note-issues, it is to be remembered that the Reserve Board can impose a tax upon them at their discretion, which tax will be added to the rate of discount to the borrower. Such a provision should accomplish the time-honored purpose of the European taxes on notes passing a certain limit. To remove all limits on notes was right; but it was a courageous thing to put it in the bill, because many people think expansion is largely to be attributed to the quantity of issues. Trouble is less likely in normal times to arise from the notes than from the possible use of deposit-accounts following loans which demand only checks as a medium of exchange.

It must be emphasized that the possibilities of undue expansion of credit cannot be removed by any legal provisions in an act. It may create machinery, but the speed with which it will be run will depend upon the judgment of the man at the throttle. Elasticity of credit has been given us with all its possibilities of good to business, together with all its possibilities for abuse. The whole safety of our credit fabric, therefore, rests upon those who pass on the paper discounted. Consequently, the success of the new system depends chiefly on the men selected to manage the several Reserve Banks. In practical operation, they are more important than those on the Reserve Board.

§ 8. The new act has made possible a departure of very great importance in the technical methods of clearings and collections. It is a further development of economizing devices in the settlement of credits. For a long time the charges of clearing-houses have been a

source of dissatisfaction. The original field of clearing-houses was limited to local banks in one city, but later it was extended somewhat by such a system as that inaugurated by Boston, Kansas City, and some other cities. In the new act larger questions of joint action over wide districts, or even over the whole country, are raised. The problem is: Can the gains of city clearing-houses and collections be extended to the whole territory of the United States?

All the original regulations touching this matter in the act[1] are as follows:

Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, or checks and drafts upon solvent member banks, payable upon presentation; or, solely for exchange purposes, may receive from other Federal reserve banks deposits of current funds in lawful money, national-bank notes, or checks and drafts upon solvent member or other reserve banks, payable upon presentation (sec. 13).

Every Federal reserve bank shall receive on deposit at par from member banks or from Federal reserve banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal reserve bank, checks and drafts drawn by any depositor in any other Federal reserve bank or member bank upon funds to the credit of said depositor in said reserve bank or member bank. Nothing herein contained shall be construed as prohibiting a member bank from charging its actual expense incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal reserve bank and the charge which may be imposed for the service of clearing or collection rendered by the Federal reserve bank (sec. 16).

[1] Later these were amended, March 3, 1915, September 7, 1916, and June 21, 1917.

In these sections, in spite of some blundering due to a compromise on technical questions, and from a desire to conciliate country banks (whose earnings are largely affected by charges for collections), some important advances were made: any Federal Reserve Bank may receive on deposit from its members or from the United States checks and drafts drawn on any solvent member bank; "for exchange purposes" any Federal Reserve Bank may accept from any other Reserve Bank checks and drafts drawn on any solvent member bank or other Reserve Bank; but it is said (Sec. 16) that such items shall be received at par; while elsewhere certain charges are allowed for collecting them, which has been interpreted by exchange experts as making no charge for exchange, but allowing a charge for cost of service. But independent of "exchange purposes," any Reserve Bank must receive at par from member banks, or from other Reserve Banks, checks and drafts drawn on any member bank in the system, that is, without a charge for exchange; but yet a member bank is not to be prohibited from charging actual expenses for collection or exchange to its patrons.

The Reserve Board is to fix the charges levied by member banks on patrons if these checks are cleared through a Reserve Bank, and also to fix the charge of the Reserve Bank for its cost of clearing or collection.

Bearing directly on a future system of clearings for the whole country, Sec. 16 provides as follows:

> The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal reserve banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal reserve banks, or may designate a Federal reserve bank to exercise such functions, and may also re-

quire each such bank to exercise the functions of a clearing house for its member banks.

Since a member bank will have reserves in its Reserve Bank, a balance in the clearings by a Reserve Bank against a member bank can be directly charged against the account of said member bank, and all charges for collection would be avoided. Any cost for handling these clearings could be charged by the Reserve Bank against member banks. A saving over the present methods is thus possible. How far a wide-reaching system of clearings may be developed, in spite of the extensive clerical service required, depends largely on organization and future dispositions. It is possible that the present city clearing-houses may be superseded.

There is, under the new law, a discrimination in favor of a check drawn on any member bank: in the future it should be received at par in any part of the country equally with New York or Chicago exchange. Therefore all past methods of drawing exchange are to a certain extent likely to be upset. Certainly checks on non-member banks will be discriminated against, and they must go through the old process of collection, which will not be so quick or so inexpensive as that of member banks. Competition of non-member banks may lower the cost, or checks on non-member banks may be collected by depositing checks of non-member banks with member banks.

The use of checks drawn by individuals on their local banks to make payments even of small sums in any part of the country lies at the bottom of the extensive system of collections and clearings in the United States. In Europe this burden is largely escaped by being thrown on remittances through banks. The new act clinches the present habit, and makes it permanent, by supplying the means of continuing it.

§ 9. It had been hoped by the friends of the National Monetary Commission Plan to introduce in this country a discount market such as exists in the financial centres of Europe. A discount market obviously means a market where certain kinds of paper can be sold at any time. To suit paper for such a market it must have universal acceptability by having a maker whose credit is accepted in any market. Established institutions, rather than private persons, are likely to be thus recognized. Promissory notes, the usual paper discounted in this country, are the promises of individuals or firms, and therefore have no wide recognition. The process of making an acceptance is as follows: The person wishing credits will go to a large mercantile house, or bank, and ask the privilege of drawing a bill on it, falling due at a date in the future, which will be accepted by them on presentation. The house, or bank, writes across the face of the bill the word "accepted," with the date and its signature. A promise to pay in the future to a bank and "accepted" by it has the security and recognition of the acceptor. Hence, the use of acceptances has been urged as necessary to the existence of a discount market in this country.

Hitherto, acceptances had not been permitted by law to national banks. Under the new act our banks were allowed to accept, as follows:

> Any member bank may accept drafts or bills of exchange drawn upon it and growing out of transactions involving the importation or exportation of goods having not more than six months sight to run; but no bank shall accept such bills to an amount equal at any time in the aggregate to more than one-half its paid-up capital stock and surplus (sec. 13).[1]

[1] Amended, March 3, 1915, to equal the stock and surplus.

The limitation of acceptances to transactions in foreign trade, and the omission of authority to make acceptances based on domestic transactions, obviously limited the supply of paper which could be offered in a general discount market. The reason for such omission was the fear of undesirable expansion, if the right to accept were given free rein. In all cases the customer asking for the acceptance agrees to provide the accepting bank with funds to cover the acceptance on or before the day it falls due. The acceptor only lends his credit, to the customer, and does not advance any cash. Hence in accepting a bill drawn on it a bank would not create a liability by a deposit-account against which it must carry reserves; and in this country the temptation to accept beyond moderation might have been too strong to be resisted, if a curb were not introduced. As the law stood, a limited use of acceptances was permitted, which might be extended by later legislation, provided traditions of safety were thereafter established. Moreover, it is doubtful if bills of exchange drawn on the actual movement of goods, or bills drawn on banks, in order to provide acceptances could be extended to such an extent in this country as to supplant the promissory note.

Besides the general market for acceptances, the new act permitted Federal Reserve Banks to deal in them:

> Any Federal reserve bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity at time of discount of not more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid-up capital stock and surplus of the bank for which the rediscounts are made (sec. 13).

If our acceptances based on cotton, for instance, were made salable in London, or on the Continent, they would

in effect provide a means of bringing in foreign capital to finance the movement of our crop. This would be an obvious advantage.

In other respects, the purpose of selling acceptances in a discount market would be to change the assets of the holder into cash. So far as member banks wish to do this, they may obtain the end in another way, by rediscounting paper with a Federal Reserve Bank; but such operations are limited by the resources of capital at the disposal of the Reserve Banks.

§ 10. So far as Americans are engaged in foreign trade, or are located in foreign countries, they labor under some disadvantage, if they are obliged to do their business through foreign banking institutions. In international relations, and in granting of loans, the trade of any one country is usually favored by the institutions owned by the citizens of that country. Our business men are not so well known that they can obtain loans from foreign banking-houses in Buenos Aires or Hongkong as favorably as those who have been long known to their commercial and banking institutions. A young country must fight for its recognition in trade; and it needs the support abroad of its own powerful banking institutions.

Moreover, American bankers were obliged to share commissions with foreign bankers on an immense amount of international trade originating with us. Formerly American drafts and bills, if sent abroad in payment of imports from Europe, could not be sold in the discount markets of Europe, because the American firms were not sufficiently well known.

As soon as our foreign trade warrants it, and as soon as we have capital enough so that a surplus can be employed out of the country, foreign banking branches, if

profitable, will come into being under the provisions of the new act (Sec. 25). Such branches are permitted to national banks having a capital and surplus of $1,000,000 or more, subject to examination by the Federal Reserve Board, and provided the accounts of each branch are kept separately from those of any other branch.[1]

§ 11. As regards the independent treasury system, the act has, unfortunately, brought no definite removal of the possibilities of past evils. Not only were more important matters attracting chief attention in the bill, but also there was an evident purpose in the administration to retain in its hands as much power as possible over the money market. Hence the act was only permissive in the provision (Sec. 15) for the deposit of government funds with the banks of the new system:

> The moneys held in the general fund of the Treasury, except the five per centum fund for the redemption of outstanding national-bank notes and the funds provided in this act for the redemption of Federal Reserve notes, *may*, upon the direction of the Secretary of the Treasury, *be deposited* in Federal Reserve Banks, which banks, when required by the Secretary of the Treasury, shall act as fiscal agents of the United States; and the revenues of the Government or any part thereof may be deposited in such banks, and disbursements may be made by checks drawn against such deposits.
>
> No public funds of the Philippine Islands, or of the postal savings, or any Government funds shall be deposited in the continental United States in any bank not belonging to the system established by this act; *Provided, however*, that nothing in this act shall be construed to deny the right of the Secretary of the Treasury to use member banks as depositories.

Nevertheless, there is so general and subconscious an understanding of the undesirability of withdrawing gov-

[1] Amended, September 7, 1916, sec. 14 (e).

ernment funds from the money market that public opinion would doubtless enforce a rational policy on the Treasury at all times; but the act leaves the avoidance of evil solely to the personal will of the secretary.

§ 12. It should be remembered, however, that it was possible under this act to require membership only of national banks. At the time of its passage there were more than twice as many banks out of the system as in it.[1] Therefore, the relations of the national to the State banks and trust companies were important and had to be reckoned with. The liabilities of the national banks to these outside institutions amounted to over $1,200,000,000; while there was due from them to national banks a sum nearly half as large as from other national banks. The desirability of creating a situation such that the State banks should find it to their interest voluntarily to join the system was early recognized. The provisions of Sec. 9 did not bring this about. The greater freedom from examinations and reports and the less stringent requirements regarding reserves and kinds of business done enjoyed by State banks gave them certain advantages in remaining out of the system. Moreover, existing provisions of State laws hindered the acceptance of the new act by State banks. On the other hand, the rise of a great emergency, like war, would make a disunited banking system a source of danger where unity of regulation and action might be a source of strength to the credit of the country. In a time of stress many State banks must undoubtedly rely for aid directly or indirectly on the Reserve Banks. Sooner or later—as in the early struggle after 1864 between the new na-

[1] By 1917 only about one-half the banking resources of the country were included in the Federal Reserve system.

tional banks and the State banks—one or the other must inevitably take the lead. It is certain that the logic of events will bring the larger part of the State banks into the Federal Reserve system.

There are many other matters which might be touched upon in connection with the new law; but within our limits it has been possible to discuss only the chief topics selected. There are unfortunate provisions in the act, such as those in Sec. 24, permitting loans on farm lands by banks that create demand-liabilities. They should not tie up their resources in an unliquid form like loans on land. But the sum and substance of the whole act is so remarkably good, that the combined support of both bankers and the public is certain to be given to it to the end that it may work smoothly and bring a long-desired reform to an expectant nation.

CHAPTER XI

WORKING OF THE FEDERAL RESERVE ACT

§ 1. The inauguration of a new banking system, involving many departures from established methods, inevitably necessitated interpretations and adjustments largely administrative in character. Practical experience also showed the need of amendments to the law. Beyond these in importance came the test of the essential principles on which the act was based, particularly when tried out in the exceptional conditions produced by the European War. No banking system could have been subjected to a harder test; and it would be strange if it had not disclosed some weaknesses either of policy or of structure.

Although the act was passed seven months before the outbreak of the war, it was nearly eleven months before the system began operations (November 16, 1914). For this delay there are none but political excuses. It was not until August 10, 1914, that the Federal Reserve Board took the oath of office. The panic of 1914 forced the organization that should have been completed months before. The subconscious belief in the new system already enacted served at the best to produce only a psychological steadying effect in the summer of 1914.[1]

The Reserve Bank Organization Committee had already located the twelve districts, designated the seat for each Reserve Bank, and secured the election of their directors. There early arose the need of defining the kinds of paper to be discounted by the Reserve Banks for their

[1] See Laughlin, *Credit of the Nations*, pp. 297–306, 350–353, for the situation during the panic of 1914.

members. After a series of orders, a final regulation of the Federal Reserve Board was issued June 22, 1917,[1] superseding previous ones, thus defining the paper which could be rediscounted under Sec. 13:

Notes, drafts, or bills of exchange, of not more than ninety days; made for agricultural (six months), industrial, or commercial purposes, and not for carrying securities (except those of the United States); the aggregate of any one borrower not to exceed 10 per cent[2] of the bank's capital and surplus (except bills drawn against actually existing values); indorsed by a member bank, and the proceeds of which are not to be used for fixed investments, such as land, building, or machinery.

A *promissory note* is defined as an unconditional promise, in writing, signed by the maker, to pay in the United States, at a fixed or determinable future time, a sum certain in dollars to order or to bearer.

A *draft* or *bill of exchange* is an unconditional order in writing, addressed by one person to another other than a banker, signed by the person giving it, requiring the person to whom it is addressed to pay, in the United States, at a fixed and determinable future time, a sum certain in dollars to the order of a specified person.

A *trade acceptance* is a draft or bill of exchange drawn by the seller on the purchaser of goods sold and accepted by such purchaser.[3]

Agricultural paper, which has a maturity of not more than six months, is a note, draft, bill of exchange, or trade acceptance, the proceeds of which have been used,

[1] *Bulletin,* July, 1917, pp. 539–543.

[2] To further the placing of government bonds this restriction was raised under certain conditions to 20 per cent by the act of March 3, 1919. *Bulletin,* March, 1919, p. 229.

[3] For terms of sale in the principal industries, see *Bulletin,* December, 1919, p. 1129, and later issues.

or are to be used, for agricultural purposes, including the breeding, raising, fattening, or marketing of live stock.

Commodity paper[1] is a note, draft, bill of exchange, or trade acceptance, accompanied and secured by shipping documents or by a warehouse, terminal, or other similar receipt covering approved and readily marketable, non-perishable staples, properly insured (September 3, 1915).

A *banker's acceptance* is a draft, or bill of exchange, of which the acceptor is a bank or trust company, or a firm, person, company, or corporation engaged in the business of granting banker's acceptance credits.

Paper of the above descriptions, properly eligible, may be discounted by any Federal Reserve Bank for any of its member banks.

Another form of paper produced far-reaching effects during the war. By act of September 7, 1916, a Federal Reserve Bank was allowed to loan directly to a member bank on its fifteen-day promissory note, secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal Reserve Banks, or by the deposit or pledge of bonds or notes of the United States.[2] The use of this device helped to expand loans on collateral of our government's war obligations to prodigious sums.

Under former banking habits, rediscounting of its customers' paper by a bank had been regarded as a mark of weakness. Under the new act that came to be the usual resort of member banks wishing to enlarge reserves. At first, however, there had been a release of old reserves, the beginning of an inflow of gold during 1915, and, in a tide of general prosperity, little need for rediscounting. There was little to indicate the coming of unprecedented

[1] Merged with other paper, *cf.* p. 284, n. 1.
[2] April 5, 1918, bonds or notes of the War Finance Corporation were included.

burdens after we entered the war. In providing perhaps $30,000,000 of discounts by the end of 1915 there was no hint of the record figure of over $8,000,000,000 during October, 1919.

Much attention was given to the introduction of acceptances among the short-time paper which could be presented to the Federal Reserve Banks for rediscount or bought in the open market. It was a matter of slow education in a community to which that form of paper was new.[1] In our foreign trade acceptances were more or less familiar, and as a cautious beginning they were made available for discount in the original act. In the first year or so there was a feeling that the system should be coddled to enable it to earn dividends. In the original act, acceptances could not be rediscounted for a member bank to an amount exceeding one-half its capital and surplus. Very soon the Federal Reserve Board was authorized, under certain conditions, to permit such acceptances to 100 per cent of their capital and surplus.[2] Later, domestic acceptances were made available, provided the member bank did not accept to more than 50 per cent of its capital and surplus.[3]

[1] For an account of trade paper and the usual character of commercial paper before the Federal Reserve Act, see *supra*, Chapter IV, Sec. 6.

[2] By act of March 3, 1915, Section 13 was amended by the addition of the following words: "except by authority of the Federal Reserve Board, under such general regulations as said Board may prescribe, but not to exceed the capital stock and surplus of such bank, and such regulations shall apply to all banks alike regardless of the amount of capital stock and surplus." As a consequence, the board publishes lists of banks to whom it is permitted to accept up to 100 per cent of capital and surplus, under Circular No. 12, series of 1915, dated April 2, 1915 (*Bulletin*, May, 1915, p. 46). The restriction to 100 per cent refers not only to the limit to which the member bank may accept, but also to the limit of discounts of such acceptances by a Federal Reserve Bank.

Also, acceptances to any one firm were limited to 10 per cent of capital and surplus, unless the bank is secured either by attached documents or by some other actual security growing out of the same transaction as the acceptance.

[3] Under the act of September 7, 1916, a Federal Reserve Bank was permitted to discount banker's *domestic acceptances*, provided shipping documents are

ıkers' acceptances were also encouraged, in the to develop a discount market at home and abroad. ‿ ˍıe end of 1915 dealings in them had risen to $100,-000,000. Such acceptances were taken by the Federal Reserve Banks mainly by purchase in the open market (together with government bonds and municipal warrants). In the discounts of the Federal Reserve Banks, however, bankers' acceptances have not yet played any important part, rising only to about $2,000,000 in one month (November, 1919). But, November 30, 1919, the Reserve Banks had purchased in the open market $495,330,000 of bank acceptances, of which $347,852,000 had been accepted by member banks.

The progress in developing a discount market in this country through the introduction and use of acceptances has been very marked of late. Various organizations have urged their adoption. Finally it has become generally understood how great an advantage it is to change dead trade accounts into live assets by adopting trade acceptances. The buyer of goods is no worse off if, instead of being a debtor to the seller on a book account, he has accepted a bill drawn on him for a certain date. There is the additional advantage for him that he is taught to pay such debts when due and not to depend on a running account which is never settled.

It is to be noted that enterprising State banks of New York began the use of acceptances for financing exports to Europe as early as August, 1914. After the inauguration, November 16, 1914, of the Federal Reserve system, national banks also began accepting bills. Since February 12, 1915, the Federal Reserve Bank of New York

attached at the time of acceptance, or which are secured at the time of acceptance by a warehouse receipt or such other document conveying or securing title covering readily marketable staples. See Regulation A, series of 1917, June 22, 1917, *Bulletin*, July, 1917, p. 540. For the act, see *Bulletin*, September, 1916, pp. 439–442.

has been buying acceptances. Probably the most effective measure for bringing about an extensive use of acceptances was the action of the New York Clearing-House, August 1, 1918, ruling that notes and acceptances could be sent through the morning clearings on the day of maturity. Acceptances are thus treated as if they were checks.[1] Finally, it has come about that institutions have been formed here, after the manner of the London Discount Houses, for the announced purpose of dealing in acceptances and foreign paper.[2] The discount market has practically arrived.

Apart from discounting for member banks (Sec. 13), the Reserve Banks had an important function intrusted to them in the power (Sec. 14) to engage in open-market operations. Large and important consequences might follow from this power, especially as affecting market rates of interest, and holdings of gold exchange or public securities. The banks might be able, in periods when there were few demands for discounts from member banks, to steady the rate of interest. Also the Reserve Banks could thus invest idle funds in paper of various kinds other than that indorsed by a member bank, and in securities, which would increase their earnings over and beyond ordinary discounting. By these operations purchases were made of bankers' acceptances on a considerable scale. The regulations for the actual practice of the system were dated December 4, 1915.[3]

[1] See *Bulletin*, September, 1918, pp. 819–821. The client should place the accepting bank in funds on the day of maturity either by deposit of clearing-house funds one day prior to maturity; or by cash or check on the Federal Reserve Bank of New York on day of maturity; or by debit to client's bank account against funds cleared prior to such date.

[2] The Union Discount Corporation was directed to cotton acceptances. Several other houses, however, have been organized for general acceptance operations.

[3] Circular No. 20, series of 1915. See also Special Instructions, No. 2, dated September 15, 1916. *Bulletin*, October, 1916, pp. 529–534.

In regard to rates, it was obviously the policy from the beginning to establish low and uniform rates. There was a desire to have the Reserve Banks made serviceable. Looking back, there is a question whether rates were not fixed at a level which tended to too great expansion of loans, especially those afterward made for carrying government obligations. At the close of 1915 the rates on bankers' acceptances were little over 2 per cent; trade acceptances about 3½; 90-day paper at 4 and 4½; commodity paper[1] at 3 and 3½. Such rates must have encouraged rediscounts. When we entered the European War in 1917, however, a change of importance took place. Preferential rates were established in favor of notes secured by government certificates or bonds.[2] As low as 3 per cent was granted for 15-day paper of this sort; and in general it was intended that the rate should correspond with the rate paid by the bonds. Such a policy may have been justified by the necessity of selling bonds; but, whatever the reason, it was a great departure from the fundamental principles of the Federal Reserve Act. It favored, instead of discriminated against, loans based on securities as collateral. That an enormous change should take place in the character of the liquid holdings of the system was certain. Consequently, it was inevitable that difficulties should arise, and that at the end of 1919 the rate on loans secured by war obligations should be raised to 5½ per cent in order to force their liquidation, no matter how painful the process might be. It is a question whether the rates should not have been raised on this kind of paper long before. The rise in the rate of discount should be used as a preventive rather

[1] Commodity rates were designed to appeal to the growers of cotton and grain. December 3, 1917, this kind of paper was merged with other commercial paper. *Annual Report*, 1917, pp. 11, 103.

[2] See *Bulletin*, June, 1917, p. 425.

than as a cure. In December, 1917, while rates in general were raised, a preferential rate was still given to war paper.

One form of paper, however, was anomalous and had no place in the system. The treatment of farm paper was governed more by political than by legitimate banking considerations. In the original act (Sec. 13) agricultural paper, having a maturity not exceeding six months, was comprised in the provisions maintaining the fundamental liquidity of paper to be discounted by a Reserve Bank.[1] An inconsistent provision, however, was wrongly introduced in Sec. 24, allowing country banks to loan on farm lands for five years to 50 per cent of the value of the land; but such loans were limited to 25 per cent of the bank's capital and surplus, or to one-third of its time-deposits.[2] This was contrary to the spirit of the act. Such loans should have been made only by banks such as were later organized separately under the Federal Land Bank Act.[3] But an amendment to the Federal Reserve Act, September 7, 1916, went further in the wrong direction by admitting loans on real estate as distinguished from those on farm land.

§ 2. The original act required that the capital should be paid in gold, but that the reserves might be paid in lawful money, or even that one-half might be in the form of rediscounted paper. It was also understood that banks might draw on their city correspondents for funds for this purpose. Before the opening of the system,

[1] Rediscounts of six months' paper were limited to 198 per cent of the subscribed capital of a Reserve Bank. *Bulletin*, September, 1916, p. 443, and Regul. G, *Fourth Annual Report*, p. 175.

[2] Regulation I, series of 1915, *Bulletin*, May, 1915, p. 43. *Cf. Annual Report*, 1916, p. 163.

[3] Enacted July, 1916, and organized March, 1917.

however, the Reserve Board [1] urged each bank to make payment in its own gold and from its own vaults. Since reserves could be had by rediscounting paper, there was no reason for member banks to hoard gold. The result appeared in the first published account, which is interesting for comparison with recent expanded accounts:

Nov. 20, 1914 [In millions]

Liabilities		Assets		
Capital	$ 18.1	Loans		$ 5.6
Deposits	227.8	Investments		...
Federal Reserve notes	1.2	Other resources		.1
		Gold	$204.9	
		Lawful money	36.5	
		Total cash		241.4
	$247.1			$247.1

The reduction in the reserves to be carried by member banks under the new act (Sec. 19) came when the old national banks were below the legal reserves in the panic of 1914. There was, therefore, a very considerable release of reserves, and an easement of the market rate, when the new system went into operation. The act set a transition period of three years, ending November 16, 1917, within which reserves were to be partly withdrawn from the vaults of member banks and gradually placed with the Reserve Banks. At the end of this period about one-third of the required reserves were to remain in the vaults of country and reserve city banks. There was a fear of disturbance during the process. In the act of August 15, 1914, some slight changes were made in the fractions to be held at home and in the Reserve Banks.[2]

[1] Circular No. 10, October 28, 1914. *First Annual Report*, p. 167.

[2] Also a State bank, becoming a member, might for a time, under certain conditions, keep its reserves with a non-member bank. But no member bank should, without consent, obtain discounts from a Reserve Bank for a non-member bank. See *First Annual Report*, p. 45.

By November 26, 1915, member banks had without difficulty paid into the Reserve Banks $321,068,000 of gold. The State banks showed little disposition to join the new system, and several States lowered the legal reserves for their banks. In such cases the general reserve system was weakened to allow State banks to compete with member banks now supported by the ability to gain reserves at any moment by rediscounts. In the act of September 7, 1916, member banks were permitted to carry in Reserve Banks any reserves then required to be kept in their own vaults. At the same time efforts were made, in 1916, to hasten the final movement of reserves to the Reserve Banks and not to wait until November 16, 1917. Because of the abnormal imports of gold due to excessively large war exports, it was believed the member banks could advance their payments of reserves and also strengthen the gold holdings of the Reserve Banks. The act of June 21, 1917 (Sec. 10), finally carried this policy into effect, and at the same time lowered the percentage of reserves. Section 19 of the Federal Reserve Act was so amended [1] as to provide for the immediate transfer of all reserves to the Federal Reserve Banks; and the amounts of required reserve were fixed as follows:

	Demand-deposits Per cent	Time-deposits Per cent
Country banks	7	3
Reserve city banks [2]	10	3
Central reserve city banks	13	3

Thereafter member banks were not required to carry any reserves in their own vaults; but the new amend-

[1] See *Federal Reserve Bulletin*, July, 1917, pp. 508, 517. The weekly statement of June 23, 1917, appears in the revised form.

[2] For the revised list of reserve cities, see *Annual Report*, 1917, p. 30.

ments had the effect of obliging the banks to increase their former holdings with the Reserve Banks.

To this point we have been concerned with reserves kept for deposits. But we are already confronted with a shortcoming in the Federal Reserve system through the confusion of notes and deposits. The two are unscientifically mixed together. The reserves in gold behind the notes ought to be kept distinct from any regulations for reserves behind the deposits. In practice, it was desired to encourage the deposit of gold for reserve notes even to 100 per cent, so that they would serve the same purpose as gold certificates. Unfortunately the act is structurally weak at this point. Since only 40 per cent in gold is required behind the notes, the additional gold could be transferred to reserves behind deposits, in exchange for commercial paper. Thus practically a new basis for reserves in gold was established in June, 1917.[1] As time went on and the system was strained in the effort to carry enormous loans based on war and other obligations, the consequent rise of the deposit item due to discounts directly affected the percentage of reserves behind both notes and deposits. But the ratio computed on both notes and deposits was confusing and gave no true understanding of the situation.

§ 3. There had always existed some antipathy between national banks and those chartered by the States. Yet from the passage of the Federal Reserve Act it was the evident purpose to unify all the banks of the country. State requirements had been less severe regarding reserves, examinations, etc.; and State banks had been granted many auxiliary privileges—low reserves against savings-accounts, powers to act as executor, trustee, ad-

[1] See *Bulletin*, July, 1917, pp. 503–504.

ministrator, registrar, etc., not permitted to national banks—at the same time that they carried on the banking functions of deposit and discount. Thus large banks had grown up outside the national banking system. From the start, overtures were made to State banks to join the new system, but to little avail. Of course, a State bank on entering must conform to requirements established for all member banks; but the laws of some States afforded difficulties. There was strenuous objection by the smaller banks to the loss on collections involved in going into the new system with its clearings at par; but also to new examinations and intricate statements as well as to the loss of interest on balances, if reserves were to be transferred to the Reserve Banks.

In the main, State banks and trust companies had grown up in competition with the national banks, until they were far greater in number, because of forms of business not allowed to national banks. If, therefore, it were to be made easy for State banks to become members, it was obvious that national banks should not be cut off from those forms of business formerly confined to State banks. This was granted in the original act,[1] but later (September 26, 1918) guarded by requiring separate accounts for trust funds and the like. Nevertheless, these provisions were regarded as an intrusion into the private preserves of State banks; and their constitutionality was even denied.[2]

The dealings of directors and attorneys with a bank in Section 22 of the original act caused difficulty. In order to prevent illegitimate operations by which officials

[1] Sec. 9 (K). To grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, or registrar of stocks and bonds under such rules and regulations as the said board may prescribe.

[2] See *Annual Report*, 1915, p. 12.

could make a profit in bringing business to the bank, the act had practically prohibited directors from doing business with the bank.[1] The act of September 26, 1918, while providing against improper transactions, permitted dealings in the regular course of business between a member bank and its directors, or a firm to which they belonged, with certain publicity of details.

It soon became clear that State banks could earn more[2] by joining the new system and transferring reserves to Reserve Banks, because a large part of them could be invested in a form which would serve as safe secondary reserves. Moreover, Section 9 was so amended by the act of June 21, 1917, as to allow a State bank or trust company to retain its full charter and statutory rights, with all corporate powers granted it by the State, and yet become a member of the new system.[3] Changes in State laws also removed obstacles. Finally, all objections seem to have been removed. Even then many State banks remained out. No marked change, however, appeared until the necessities of the war brought the stimulus sufficient to cause a general movement into the new system. The appeal of President Wilson, October 13, 1917, for a complete mobilization of the banking and credit resources of the United States, because of our entry into the European War, was met by a patriotic response from State banks.[4] The largest

[1] See *Bulletin*, June, 1918, pp. 513–515.

[2] See *Bulletin*, July, 1918, pp. 615–622.

[3] It was not subject to examination by the comptroller. Also examinations by State authorities might be accepted, if approved by the Federal Reserve Board. See *Bulletin*, July, 1917, p. 512. It could withdraw on six months' notice, and was unaffected by Sec. 8 of the Clayton Act, relating to interlocking directorates.

[4] Yet as late as June, 1918, there were about 8,000 eligible State institutions with a capital of about $695,000,000 and surplus of $425,000,000 out of the system. At the end of 1919 there were 1,181, with capital of $421,000,000 and surplus of $447,000,000 in the system.

State banks are as a rule now in the Federal Reserve system.

§ 4. The obvious intent of the Federal Reserve Act (Sections 13, 16) to take over the clearing of checks raised a question of serious difficulty, not only because it warred against established customs but against the close relations of banks with their city correspondents. Moreover, the system could control only member banks. The stumbling-block lay in the matter of charges for collection and exchange. In the past the reserves kept with correspondents had been drawn upon for exchange, and banks had made a charge for collection.

March 4, 1915, the Reserve Board provided for the voluntary clearing of checks within each district.[1] It did not supersede existing local clearing-houses, nor did it cover the clearing of checks between banks in different districts, nor the settlement of balances between Federal Reserve Banks. Meanwhile, October 4, 1915, checks on the Richmond Reserve Bank were by arrangement received at par by the New York Reserve Bank. Early in December, 1914, the St. Louis and Kansas City Reserve Banks had permission to apply a required system to their members; but, when the voluntary system was later introduced, 80 per cent of the St. Louis district and all of the Kansas City district continued their membership. The loss of exchange business and the opposition to having a check which a bank had not seen charged against its account at a Reserve Bank worked against the success of the plan.

In April, 1916, a more comprehensive plan was elaborated to go into effect July 15, 1916. Each Reserve Bank was required to exercise the functions of a clearing-house

[1] See *Bulletin*, May, 1915, p. 6, and June, 1915, p. 78.

for its members on interdistrict checks. No member bank was required to use it; and members could still keep accounts with correspondents; but they must pay at par all checks drawn on them and presented at their own counters. Federal Banks presented checks by mail, but did not debit items until returns came back from each bank.[1] Checks on State banks that could be collected at par were received. Subject to a small service charge (not over 2 cents per item) par collections by the end of 1916 extended to over 15,000 banks. It was an advantage to a bank as against a competitor that its checks were receivable at par. On July 15, 1916, the Federal Reserve Bank of Boston took over the work of the Boston Clearing-House, and collected checks on all banks (including State banks) in its district without charge (except a service charge of 0.9 cent per item).

The act of September 7, 1916, and of June 21, 1917, amended Section 13 of the Federal Reserve Act, in order to extend clearings to those non-member banks which maintain with a Reserve Bank a balance sufficient to cover items presented for exchange or collection. Member banks were allowed to charge for collection, but not over 10 cents per \$100; but no charge could be made against a Reserve Bank.[2]

When reserves were no longer (after June 21, 1917) held in other banks nor in a bank's vaults, there was no reason why exchange should not be drawn on Reserve Banks, nor was there anything to restrict clearings by member banks through the new system except the matter

[1] See *Bulletin*, June, 1916, p. 262; July, 1916, p. 312. Regulation J, series of 1916 (*Bulletin*, October, 1916, p. 542), superseded former ones.

[2] An opinion was rendered by Attorney-General Gregory, March 21, 1918, excluding non-member banks from limitations as to charges. See *Bulletin*, May, 1918, pp. 367–371. See also *Annual Report*, 1917, p. 23, on the Hardwick Amendment.

of charges for the expense incurred. Country banks had been accustomed to make a charge for exchange in remitting for checks drawn on themselves, but by the new system they must remit at par. The power to fix charges remains in the hands of the Federal Reserve Board, but there has been much opposition to the compensation granted.[1] Great efforts, nevertheless, have been made to have all the banks in a State join the par list. At the end of 1919 there was a daily average of clearings of over $600,000,000 by 9,055 member banks and 15,851 non-member banks on the par list.[2] But as yet the system is not universal.

A system of transfer drafts also has been inaugurated, by which a draft of a member bank on its Reserve Bank may be paid without time allowance or deduction at any other Reserve Bank. Such a method requires the existence of the Gold Settlement Fund at Washington as a means of clearing between the twelve Reserve Banks. This fund was established as early as May 27, 1915.[3] By this means the title to funds in one district can be transferred to another without the actual movement of money. Each Reserve Bank is required to keep in this fund with the Treasury of the United States a balance of not less than $1,000,000. Reports are made on each Wednesday evening by telegraph for the "checker-board," and weekly statements are issued. The first withdrawal was made July 14, 1915, by a telegram from the Federal Reserve Bank of Chicago, filed at 10.30 A. M., and at 2.30 P. M.

[1] See the Report of the "Committee of Five" of the American Bankers' Association, *Bulletin*, October, 1918, p. 962. *Cf. Bulletin*, May, 1918, p. 371; September, 1918, p. 819.

[2] *Bulletin*, January, 1920, p. 94. The map showed the Southern States as a whole not on the par list. *Cf. Bulletin*, December, 1919, pp. 1113–1114. For meaning of "par," see *Bulletin*, July, 1916, p. 310.

[3] Regulation L, series 1915, *Bulletin*, June, 1915, p. 78. *Second Annual Report*, pp. 77–79.

of the same day the assistant treasurer of the United States at Chicago was ready to make payment to the Chicago Bank of the $2,000,000 requested.[1] In September, 1915, transfers in the Gold Settlement Fund were authorized between each federal reserve agent and Federal Reserve Banks.[2] The Federal Reserve Agents' Fund consisted of gold deposited for safe-keeping with the Federal Reserve Board and held by them to reduce the liability of Reserve Banks against Federal Reserve notes outstanding. At first, gold order-certificates on the treasurer in denominations of $10,000 were used, but have been discontinued. The total volume of clearings through this fund during 1918 amounted to $26,962,946,500, the large figure being chiefly due to sales of government obligations. But the transfers also prevented the old shifting of funds for crop-moving purposes.

The success of the Gold Settlement Fund in saving shipments of gold within one large country has suggested the possibility of an international gold exchange fund for commercial transactions between nations. It seems clear, however, that the depreciation of European money will for many years postpone any such plan.[3]

§ 5. The Federal Reserve system began operations in 1914 when we owed a large sum of gold to Europe. Our phenomenal exports of goods, however, from 1915 entirely reversed the movement of gold. As a consequence our banking and currency system, by an unequalled stroke of good fortune, and in spite of the expansion due to the war, has been throughout maintained on a basis of unequivocal convertibility into gold. The exceptional im-

[1] *Bulletin*, August, 1915, p. 183.
[2] *Bulletin*, October, 1915, p. 303.
[3] See *Fifth Annual Report*, p. 35. As concerns South America and the western hemisphere, see *Bulletin*, March, 1919, p. 198.

ports of gold and the concentration of reserves brought about by the new banking system united to raise the gold reserves of the Reserve Banks at the close of 1919 to $2,078.4 millions. It is estimated that $300,000,000 of hoarded gold have been returned to the banks since the armistice.[1] To prevent gold escaping to enemy countries, since September 7, 1917, an embargo was placed on the exportation of gold.[2] The original act did not provide for the direct issue of Federal Reserve notes against gold deposited with Reserve Banks. For a time the Reserve Banks deposited surplus gold with reserve agents, and, by withdrawing the pledged paper, thereby reduced their liability for notes outstanding. Thus at the close of 1916, of $300,110,000 notes, only $17,588,000 were secured by commercial paper. But by the act of June 21, 1917, it was proposed to make the note function as a gold certificate. Unfortunately a 40 per cent reserve of gold does not make a gold certificate.[3] As we shall see later this was a means of unduly expanding credit, because the excess gold was transferred to reserves for deposits. At the time, however, it served to augment the gold holdings of the Reserve Banks.

With over $2,000,000,000 in gold,[4] with an amazing excess of exports of goods, a creditor to other nations, thereby possessing the claim through the foreign exchanges over funds in other countries, the position of the United States was almost incredibly strong as regards the gold basis. It is now the only country which can offer a free market for gold. And yet in spite of such

[1] *Bulletin*, July, 1919, p. 616.

[2] Removed June 26, 1919, with a few exceptions affecting Russia. See *Bulletin*, September, 1919, p. 853.

[3] The jubilation on this matter (*Fourth Annual Report*, p. 12) is scarcely justified.

[4] Exclusive of gold in the Treasury and national banks. For the gold reserves of the world, see *Bulletin*, February, 1919, p. 140.

good fortune we have a situation in 1920 in which we have actually reached the limit of our banking credit, due to loans based on unliquid war obligations, and to the pressure for loans in other directions.

§ 6. In foreign operations the original act (Section 14) allowed Reserve Banks to establish foreign agencies, to deal in cable transfers and eligible paper with foreign banks; and also (Section 25) permitted our national banks, having a capital and surplus of $1,000,000, to establish branches in foreign countries. The limitations of these provisions led to demands for more latitude. The secretary of the treasury opposed the creation of independent foreign banks, and urged the entrance of the Federal Reserve Banks into Latin America through joint agencies; but the board was adverse to locking up its reserve funds in loans of the character available in those countries.[1] The act of September 7, 1916, then permitted a bank to subscribe not exceeding 10 per cent of its capital and surplus to the stock of banks chartered in the United States to carry on foreign banking under some regulation by the Federal Reserve Board.[2] Finally, greater freedom was allowed by the Edge Act[3] of December 24, 1919, by which federal corporations, under the approval of the Federal Reserve Board, were authorized in foreign dealings to carry on the functions of discount and deposit, and even to issue notes. They may also be asked to serve as fiscal agencies for the Treasury.

Under Section 14 the Federal Reserve Bank of New

[1] See *Bulletin*, October, 1915, p. 313, and November, 1915, p. 348.

[2] At the end of 1918 the National City Bank of New York had established more than a score of foreign branches, and the First National Bank of Boston one in Buenos Aires. See *Bulletin*, October, 1918, p. 942, and November, 1918, p. 1079. In addition five banking corporations had qualified. *Fifth Annual Report*, p. 59. For list at end of 1919, see *Bulletin*, December, 1919, p. 1154.

[3] See *Bulletin*, January, 1920, pp. 56–59.

York was authorized, December 25, 1916, to appoint as its foreign agent the Bank of England. Accordingly, June 7, 1917, obligations in London amounting to $50,000,000, due to Americans, were paid to the Bank of England. The Reserve Bank of New York assumed the obligation to American holders of the paper (properly distributed to other Reserve Banks), but the gold, "earmarked" by the Bank of England, became a part of the reserves of our Reserve Banks under the item "Gold held with foreign agencies." Likewise, February 28, 1917, the Reserve Bank of New York established an agency with the Banque de France at Paris.[1] In June, 1918, foreign exchange with Italy was made subject to the approval of the representative of the Italian Institute of Exchange.[2]

§ 7. No other event can compare in importance and in its effect on the Federal Reserve system with the European War. Not only did it touch every function of banking, but—most significant of all—it put to the test and brought out all structural weakness. In Europe the tremendous strain on banking systems showed the inferior quality of the French and German to the English.[3] Yet in the United States, in the matter of placing government loans, we tended to follow Continental rather than English experience as regards borrowing directly from the banks. In Great Britain and in the United States alone is there the same method of using checks drawn on deposits as a means of payment, instead of using bank-notes as on the Continent. And yet we tended away from the very genius of English and Ameri-

[1] See *Bulletin*, January, 1917, p. 5, and March, 1917, p. 175.

[2] *Bulletin*, July, 1918, p. 594.

[3] See Laughlin, *Credit of the Nations*, chaps. III, IV, and V.

can practice in being led to depend largely upon issues of notes. This tendency has been seen in preceding chapters. In the war our banking policy was dominated by a political rather than by a banking intelligence.

In Great Britain the Bank of England is used strictly as a fiscal agent to whom revenues are paid and by whom expenditures are met. The bank does not itself subscribe to great loans; it acts as an agent only, except so far as the Treasury secures aid by ways and means credits at the bank. On November 23, 1915, the secretary of the treasury (under the permissive authority in Section 15 of the act) appointed the Federal Reserve Banks as depositaries and fiscal agents of the United States,[1] to take effect January 1, 1916. On that date government funds in national banks were transferred to the Reserve Banks.[2] But, after we entered the war, on the offer of the First Liberty Loan, the Reserve Banks were designated, May 14, 1917, as fiscal agents on loan subscriptions. This was the beginning of operations that involved the banks in very large transactions.

In anticipation of the bond-issue, short-term certificates of indebtedness were offered to the banks and the public. The proceeds from the latter, turned over to the Reserve Banks for the government account, were at once paid out by the Treasury for war supplies, or to the Allies, who spent the sums in this country. These expenditures immediately returned to the banks as private deposits. Thus funds subscribed to the Treasury came back before the bond-issue was offered, and prevented a convergence of payments on any fixed date. When the long-term bonds later appeared for subscrip-

[1] See *Bulletin*, December, 1915, p. 395.

[2] Already $15,000,000 had been transferred to the Reserve Banks of Richmond, Atlanta, and Dallas ($14,000,000 through the Gold Settlement Fund) to aid in the movement of cotton.

tion, the volume of outstanding certificates, which were exchangeable for bonds at par, were used in payment of the bonds chiefly by the banks; or as the government paid off the certificates the proceeds were given for bonds. Customers of banks, subscribing for bonds, would pay either by cash, by checks drawn on their deposit-accounts, or by the proceeds from loans got from the banks secured by the bonds as collateral. When member banks remitted to Federal Reserve Banks for bonds taken, they drew down their cash assets, or their reserves in the Federal Reserve Banks. But these reserves could be replenished by a rediscount of customer's paper secured by war obligations (departing thus from commercial paper, as required by the true principle of the act) at the Federal Reserve Bank, or by the direct 15-day note of member banks supported by bonds or certificates.[1] The outcome of this credit operation—while not necessarily increasing the demand of the public for more notes as a medium of exchange—was the existence of a large amount of government obligations in the assets of the banking system to protect demand-liabilities of the banks either in the form of deposits or notes. At the end of 1919 the total of these undigested securities rediscounted at the Reserve Banks amounted to $1,510,364,000.[2] Thus the banks themselves became deeply involved in the fiscal operations of the government. In passing from commercial paper to war obligations as a basis for rediscount the way was opened for an extension of credit limited

[1] This policy was encouraged by a preferential rate on such loans, as well as on those to customers of banks. Member banks were also allowed to rediscount thus for non-member banks. *Bulletin,* June, 1917, pp. 425–426. Banks and trust companies subscribing to more than $100,000 bonds were considered as depositaries, and could pay by granting a credit on their books to the Treasury. See also *Fifth Annual Report,* p. 79, for the act of April 4, 1918.

[2] The war paper held by all banks was $2,495,000,000. *Bulletin,* October, 1919, p. 943.

only by the needs of the Treasury. It is not forgotten, of course, that the original act (Sec. 14) permitted the rediscount of paper based on bonds and notes of the United States; but the context shows it could never have contemplated the use of such paper on the great scale actually permitted during the war. Also the banks came to own very large amounts of bonds as investments. Here was a great danger; for as one vast loan followed after another, the mass of unliquid securities was enormously increased, since the bonds were salable only at prices steadily declining below par. In such ways our practice differed from that of the Bank of England.

A measure, having a tendency to expand credit on collateral not acceptable to a Reserve Bank, was enacted April 5, 1918, by which the War Finance Corporation[1] was created with a capital of $500,000,000 provided by the government. The Federal Reserve Banks were forbidden to discount paper supported by stocks or bonds, although, as we have just seen, this policy (not the law) was departed from in making loans based on our government securities. But this corporation was authorized to discount for banks which granted loans to firms (whose operations were contributory to the prosecution of the war) the promissory notes of the banks secured by the collateral offered by the firm to the banks. Also, loans could be made directly to such firms under certain restrictions. Such loans might run for five years. The corporation could also issue bonds. By this act the Reserve Banks were allowed to discount the direct obligations of member banks secured by such bonds of the corporation and to rediscount eligible paper secured by

[1] For the text of the act, see *Bulletin*, April, 1918, pp. 301–306. For its *Annual Report*, see *Bulletin*, January, 1919, p. 28. This measure was in some ways similar to the resort in Germany to *Darlehnskassen*, which granted loans that would not be accepted by the Reichsbank.

such bonds and indorsed by a member bank (Section 13). Banks, having made loans to war industries not acceptable to Reserve Banks, could thus get advances from the War Finance Corporation.[1] Later the corporation was permitted to aid exporting firms.[2]

In passing to a matter of general importance, it is to be remembered that under the original act (Section 15) the independent treasury system was not abolished. It was only provided that the secretary of the treasury may deposit government funds with the Federal Reserve Banks.[3] It was at his discretion alone that funds were sent to Southern Reserve Banks in September, 1915, to help move cotton. It should be noted, also, that since the Reserve Banks have been made fiscal agents there is no reason for retaining the old subtreasuries now become obsolete.[4]

§ 8. The original act of December 23, 1913, extended the life of the Aldrich-Vreeland Act[5] one year from June 30, 1914, to June 30, 1915, and reduced the tax on its notes to 3 per cent per annum for the first three months, with an additional one-half per cent for each month until 6 per cent was reached. In the panic of 1914[6] not only were clearing-house certificates to the maximum of $109,-

[1] The Capital Issues Committee under this act passed on the question whether issues of securities were compatible with the public interest. It ceased to act December 31, 1918, and was dissolved by proclamation August 30, 1919.

[2] See Liberty Loan Act, March 3, 1919, Sec. 9. *Bulletin*, March, 1919, pp. 227–228. *Cf.* also an amendment widening such loans, *Bulletin*, October, 1919, p. 966.

[3] *Cf. supra*, p. 275. See *Bulletin*, October, 1915, p. 301, for the first deposits. Also in connection with the special deposit of proceeds of bond sales, under the fiscal act of September 24, 1917, as amended April 4, 1918, see *Bulletin*, June, 1918, p. 494.

[4] See the *Report of the Bureau of Efficiency*, January 26, 1918 (H. R. Doc., No. 867). *Bulletin*, March, 1918, pp. 172–178.

[5] See *supra*, Chapter IV.

[6] See Laughlin, *Credit of the Nations*, pp. 299–305.

185,000 issued, but the demand for an emergency currency led to an amendment of the act of 1908. The act of August 4, 1914, removed the prerequisite to note-issues of 40 per cent of bond-secured notes, raised the total issue to 125 per cent of capital and surplus, and abolished the limit of $500,000,000 to the total circulation. After these amendments Aldrich-Vreeland notes were issued for the first time to a total of $381,530,000, but were all retired by June 30, 1915. If the Federal Reserve Banks had been in operation, such issues need not have been made.

The purpose of the Federal Reserve Act was the eventual substitution of all bond-secured national bank notes by Federal Reserve notes (Section 18). As bonds of the United States were withdrawn under the act from the security for the old national bank notes, and were taken over by the Reserve Banks, these institutions were allowed the option of depositing these bonds with the comptroller and obtaining "Federal Reserve Bank notes," on the same basis as old national bank notes.[1] When the period arrived, December 23, 1915, at which national banks could begin to dispose of the bonds used to secure their notes, the total amount offered in the first quarter was $16,041,700 as against one-fourth of the $25,000,000 yearly purchases allowed. But meanwhile the Reserve Banks had been buying government bonds in the open market, which the Federal Reserve Board regarded as an offset against any allotment from those offered through the treasurer. In all but one instance the purchases in

[1] Since they are the obligations of a Federal Reserve Bank the words "national currency" are engraved on the top margin of the face of the note and "Federal Reserve bank note" on the bottom margin of the same side of the note. But they differ as to security and origin from the Federal Reserve notes, which are obligations of the United States, and which have the words "Federal Reserve note" engraved on their face.

the open market exceeded the quota to be allotted. Hence the Reserve Banks were not required to buy any of those offered under Section 18.

The conversion of 2 per cents (having the circulation privilege), however, went on into one-year gold notes and 3 per cent 30-year gold bonds (without the circulation privilege) to the amount of $30,000,000 for 1916—half and half of each. The same amount was converted for 1917. The conversion of bonds having the circulation privilege will thus tend to reduce the amount of old national bank notes outstanding. But very little use was at first made by the Reserve Banks of Federal Reserve Bank notes. Toward the end of 1917 their amount was only $12,758,885.[1] Under the Pittman Act, April 23, 1918, retiring silver certificates for silver melted and exported, Federal Reserve Bank notes of any denomination were authorized to take their place. Accordingly, these notes were increased by the close of 1919 to $254,-933,000.[2]

The old national bank notes remained in the circulation very slightly changed in amount.[3] In 1914 there were outstanding $750,671,899, and at the end of October, 1919, $722,394,325. Of the bonds bearing the circulation privilege $63,945,460 of Spanish-American War 3 per cent bonds matured August 1, 1918; but by the end of 1919 bonds bearing the circulation privilege totalled $793,115,530. The demands for circulation were strong and the bonds remained practically unchanged during the stress of war.

A most important new element, however, was introduced by the Federal Reserve notes. As a consequence

[1] *Bulletin*, January, 1918, p. 18.

[2] *Fin. Rpt.*, 1919, p. 102.

[3] To help relieve the shortage of small notes, national bank notes of less denomination than $5 were allowed by the act of October 5, 1917.

of a remarkable increase in loans at the Reserve Banks, mainly due to borrowings secured by government war obligations, there must be a corresponding increase of demand-liabilities either in the form of deposits or notes. The increase of Federal Reserve notes was the most significant feature of this period. It represented, moreover, a policy. There was a natural reason for encouraging the substitution of Reserve notes for the old national bank notes, but there was very little reduction in the latter. The encouragement to the increase of Reserve notes must rather be ascribed to the law itself and their unfortunately too direct relation to the increase of loans. That is why the emphasis on the separation of the issues from loans and deposits in Chapter IX (Section 8) seems to be of present and future importance. By the time we entered the war the Reserve notes had already grown (March, 1917) to $336,269,000; but the phenomenal increase to $3,057,646,000 in actual circulation by the end of 1919 is obviously connected with conditions produced by the war.

It was the general policy to gather into the Reserve Banks all the gold of the country; and the issue of Reserve notes whenever they could be exchanged for gold was a part of that policy. Early in 1917[1] optimistic views were held as to the possible increase of Reserve notes as emergency-issues up to $1,000,000,000 (a sum overpassed, in fact, by November of that year). The main emphasis seems to have been placed on the new status given to Reserve notes by the act of June 21, 1917. Before that date, Reserve notes could be issued only on the deposit of eligible paper; but this act authorized their issue directly for gold or gold certificates; and, under the pro-

[1] *Bulletin*, March, 1917, p. 155.

vision for a 40 per cent gold reserve behind the notes, a proviso was introduced:

> That, when the Federal reserve agent holds gold or gold certificates as collateral for Federal reserve notes issued to the bank such gold or gold certificates shall be counted as part of the gold reserve which such bank is required to maintain against its Federal reserve notes in actual circulation.

That is, after gold was obtained by federal reserve agents in direct exchange for notes, only 40 per cent of such gold need be regarded as legal gold reserve behind the notes, and the remainder could be regarded as surplus gold or as protection against deposits (after substituting eligible paper for all beyond 40 per cent of gold as protection to the notes).[1] This plan to collect gold was also furthered by not requiring member banks to carry thereafter any reserves in their own vaults. In addition, Reserve notes could be issued upon the security of 15-day notes of member banks secured not merely by eligible paper, but by government obligations. It can be seen that the policy to encourage the issue of Reserve notes was furthered by all these provisions. Although a 35 per cent reserve is held for deposits in gold or lawful money, it is quite clear that the holding of one gold reserve equally for the two demand-liabilities, notes and deposits, shifting from one to the other, is a reversion from the well-recognized policy of a separate reserve for notes back to the older and supposedly obsolete system of the old United States Banks and the State banks in the early part of the last century. Nor does there seem to be any justification, especially in the very great expansion of notes, for this retrogression. At the Bank of England, beyond a stratum of £18¾ millions of consols,

[1] *Bulletin*, July, 1917, pp. 503–504, 506–507, 510, 515.

there is a pound of gold for every pound note. Since 1838 and under the national banking system also it has been American policy to separate reserves for notes from reserves for deposits.

It is not easy to account satisfactorily for the extraordinary increase in the Reserve notes. Before their time our currency (national bank notes, greenbacks, etc.) was inelastic. It is possible that when a really elastic currency was created in the Reserve notes there was revealed a larger demand than was suspected for a medium of exchange. So far as this is true there was no inflation; for, as immediate redemption in gold is maintained, any excess would be returned at once. It may be interesting to note what calls could be made for these new notes. As gold moved into the Reserve Banks, Reserve notes would take their place in the hands of the public. In fact, the gold holdings of the Reserve Banks amounted (December 26, 1919) to two-thirds of the notes in circulation. And in the year from July 1, 1918, the gold certificates in circulation diminished by $287,991,138.[1] Moreover, non-member banks no doubt carry Reserve notes in their reserves. As they were permitted to borrow on security of war obligations through member banks they could thereby increase their lending power by calling for Reserve notes. Thus the desire to sell bonds must have led to an increase of notes and to a considerable expansion of loans by banks outside of the reserve system. Again, it is probable that during the war the amounts absorbed by the public in circulation were greatly increased. Those who did not deposit in banks came into possession of more money than ever before. Wages had been greatly increased, and the workers retained currency in large sums. An increase of only $50 per capita in these

[1] *Finance Report*, 1919, p. 553.

classes would account for almost the whole increase in the Reserve notes. In addition, the rise of prices from 100 to 219 would require more than twice as much money to be passed from hand to hand for the same quantity of goods as were exchanged in 1914. It is also stated that much of our currency (almost the only one in the world equal in value to gold) was drawn off to Canada, Mexico, Cuba, Philippine Islands, Hawaii, Porto Rico, Santo Domingo, Haiti, Honduras, and Panama.[1] If these notes were redundant it would be quickly shown by the redemptions; but there has been little evidence of a redundancy as yet. The increase in Reserve notes[2] at various dates may be stated as follows:

[In millions]

	Reserve notes	All money outside Treasury and Federal Reserve system
April 4, 1917	$ 376.5	$4,100.9
June 27, 1917	508.8	....
November 21, 1917	1,015.8	4,131.1
April 18, 1918	1,514.2	4,266.8
August 22, 1918	2,032.8	4,449.8
October 17, 1918	2,502.4	4,925.9
October 10, 1919	2,741.6	4,958.9
December 26, 1919	3,057.6	5,172.2

It will thus be seen that from our entrance into the war, the Reserve notes increased far more than the total money in circulation; that from November, 1917, the increase of Reserve notes was over a billion dollars more than the total. It is likely that not all of this increase was needed as a medium of exchange.[3]

[1] *Fin. Report*, 1919, p. 20.

[2] *Bulletin*, November, 1919, p. 1046, and January, 1920, p. 109.

[3] The discretionary charge of a rate of interest on the notes to force retirement was never used. *Bulletin*, June, 1916, p. 273. A separate rate on notes issued under the War Finance Corporation Act could be charged.

§ 9. Whatever the system of banking, in whatever country, the test of its management and the soundness of its condition is to be found in the character of its assets. By the very nature of a commercial bank, as distinct from a mortgage company or a savings-bank, its immediate liabilities—its demand deposits and notes—depend for their payment on the assets being liquid and quickly convertible into cash. That is the reason why short-term paper is essential to liquidity. The cash reserves are only a stop-gap. If loans were not based on transactions whose proceeds would liquidate the loans at their maturity, cash reserves, no matter how large, would soon be used up. When that happens, even with great but unliquid assets, a bank must suspend payment and go into liquidation. The difference between success and failure lies in the ability to maintain liquid assets. How far the Federal Reserve system has travelled on this dangerous road it is our duty to report.

An expansion of credit is not to be tested by the quantity of its demand-liabilities—its deposits and its notes—but by the liquidity of its assets in the loan item. No matter how large these two forms of immediate liability, for which cash can be demanded at any moment, if loans are being constantly, day by day, paid off and new ones of the same quality taking their place, in totals as large as their liabilities, then all is safe. The Federal Reserve Board, in a different way, defined inflation "as the process of making additions to credits not based upon a commensurate increase in the production of goods." [1] If this means that loans made on commercial paper directly related to the production and sale of staple goods could not lead to inflation, then it would follow that loans made on

[1] *Bulletin*, July, 1919, p. 614.

unliquid assets would inevitably lead to inflation. That there has been an expansion of credit, practically resulting in drawing down our ratio of reserves to demand-liabilities to the danger-point, there can be no doubt. Nor is the cause of this expansion in any way obscure. Whether we could have escaped it or not, the fact is that, as a result of mixing banking with the fiscal operations of the Treasury, the banks of the country have become heavily loaded with more or less unliquid assets in the form of war obligations and war paper, amounting in June, 1919, to $6.5 billions.[1] The amount of war paper, or loans on collateral of war obligations, was about $2.5 billions. That this very large increase of loans was followed by an increase of notes and deposits goes without saying. Nor can these demand-liabilities be reduced until the loans have been paid off.

As early as the summer of 1917, after the first war loan and the passage of the act of June 21, 1917, there were suggestions as to undue expansion. There was already a relative increase of war paper and a relative decrease of commercial paper. The extension of acceptances was side-tracked. It was assumed that the loans to buyers of bonds would be temporary, and rather light-heartedly war paper was encouraged by being given a preferential rate of discount even over good commercial paper.[2] In truth, the reverse ought to have been the policy, so that saving and the liquidation of war paper would have been forced, especially if other government loans were certain to follow. Toward the end of 1917 the board clearly saw the danger from unliquid assets. Already the financing of British short-term notes, made the basis for ac-

[1] *Bulletin*, October, 1919, p. 943.

[2] *Bulletin*, June, 1917, pp. 425, 430, and October, 1918, p. 922.

ceptances, but to be successively renewed, had been tabooed as creating unliquid assets. Also, the same method for domestic corporations was opposed,[1] the board saying:

> The system must use every effort to maintain its liquid character and . . . commercial paper regarded as eligible for discount must be of a kind calculated to provide its own means of liquidation. Admission of long-term obligations, or obligations short-term in form only, . . . was regarded as unquestionably opening an avenue of danger to the system.

But yet, obligations of our government were admitted as a basis of loans, even though it produced unliquid assets. In the year 1918, with its succession of enormous government loans, the expansion rapidly proceeded. In February renewals by member banks were noted. The securities owned by the banks increased markedly, the national banks alone having added by the end of 1917 $910,000,000. By October, 1918, the total investments of Reserve Banks had risen to $2,295,000,000, and of member banks to $14,022,000,000. As a consequence, deposit-liabilities of Reserve Banks rose to $1,580,000,000, and of member banks to $11,731,000,000.[2] Meanwhile the percentage of cash reserves to deposits and notes which had been over 80 in the summer of 1917, fell to nearly 50[3] by the end of 1918, and at the end of 1919 to 44.8 (while at the Reserve Bank of New York it was about 40 in November, 1919). Since then it has fallen even lower. The whole situation of the Reserve Banks may be seen from the account of December 26, 1919:

[1] *Bulletin*, December, 1917, p. 922. *Cf. ibid.*, 1918, p. 249.
[2] *Bulletin*, November, 1918, p. 1048.
[3] See table, *Bulletin*, February, 1919, p. 137.

[In millions]

Liabilities			Resources		
Capital paid in		$ 87.3	Discounts:		
Surplus		81.1	Secured by government war obligations	$1,510.4	
			All other	684.5	
Deposits:			Bills bought open market	585.2	
Government deposits	72.3		Government bonds	26.8	
Due to members (reserve account)	$1,786.9		Victory notes	.1	
Deferred availability items	822.7		U. S. certificates of indebtedness	273.5	
Other deposits	97.7		Total earning assets		$3,080.5
			Cash:		
Total gross deposits		2,779.6	Gold and gold certificates	229.4	
Notes in circulation:			Gold Settlement Funds	352.8	
Federal Reserve notes		3,057.6	Gold with foreign agencies	134.3	
Federal Reserve Bank notes		261.0	Gold with reserve agents	1,240.0	
Other liabilities		58.8	Gold Redemption Fund	121.9	
			Total gold reserves	2,078.4	
			Legal-tender notes, silver, etc	57.1	
			Total cash		2,135.5
			Uncollected items		1,075.1
			5 per cent Redemption Fund (Federal Reserve Bank notes)		13.2
			Bank premises		13.0
			All other resources		8.1
Total liabilities		$6,325.4	Total resources		$6,325.4

When examining the condition[1] of member banks, however, at the end of 1919 we find the expansion of loans not so much in carrying government securities as in other paper:

[In millions]

Loans secured by U. S. obligations	$1,022.7
Loans secured by other than U. S. stocks and bonds	3,270.5
All other loans and investments	9,339.9
Total U. S. securities owned	1,981.7
Total loans and investments	$15,614.8

[1] *Bulletin*, January, 1920, pp. 103–104. Figures are not given by which a comparison can be made with conditions before we entered the war, April, 1917.

Against these assets there were liabilities:

[In millions]

Net demand-deposits	$11,195.1	
Time-deposits	2,293.4	
Government deposits	647.9	
		$14,136.4
Reserve balance with Federal Reserve Bank		1,316.9
Cash in vault		403.5
Total reserves		$1,720.4

In this account the character of "all other loans" is far more important than that of the war paper. Moreover, of bills rediscounted with Reserve Banks, only $306.3 millions were secured by government war obligations. Of bills payable with Reserve Banks, $841.4 millions were thus secured. It seems to be clear that the expansion of credit was by no means confined to war paper.

§ 10. It would have been surprising if any banking system could have been created which would not have shown some defects of structure under the phenomenal and unparalleled strains of the European War. Nor is it to be expected that no mistakes of policy should have been made by the management.

First of all the lessons to be learned from our unusual experience is that there is need of better control over undue expansion of credit. For a time the official publications of the board showed a naïve jubilation at the unlimited banking power of the system. This policy had a tendency to encourage a resort to the system for purposes inconsistent with the fundamental purposes of the act. No banking system can look forward to an inexhaustible fund of credit. Limitations are set by the amount of available banking capital, the thrift of the community by which alone additional capital can be

supplied, and by the turnover of staple goods which is dependent on the efficiency of the productive processes in the various industries. It was amazing that, in spite of other demands, our people could supply in taxes and loans to the government the means to cover the cost of the war (about $34,000,000,000). When the need of credit from the banks was called upon in placing enormous loans, it was obvious that continuing industrial needs must also be cared for. By the end of 1919 the combined demands of both these factors had practically reached the limits of our banking power. Even though commercial needs were restricted it was properly urged that necessary operations must be hindered unless assets in the form of war paper were taken up by the public. This was only an appeal for more capital through new saving by subscribers to loans.

It is a question whether the inevitable limitations of credit were sufficiently foreseen and duly provided for. As we have noted, the fear of inflation was present in 1917 and frequently stated. But what was done to prevent it? The time-honored remedy was the increase in the charge for loans. The board asserted that it was not possible to raise the rate of discount while government loans were being placed. It is not certain, however, that a higher rate on war paper would have so reduced the patriotic feeling of the country that the loans would not have been subscribed for. Subscriptions in general would hardly have been antagonized by so relatively small a matter as the rate to borrowers on the part of the loans which required bank credit. For war paper the preferential rate was of questionable wisdom. It encouraged borrowing on the security of bonds, as compared with liquid commercial paper. Under general principles war paper ought to have been charged a higher rate. The

application of the break on expansion of credit by a higher rate of discount should have come before a serious emergency had arisen. In fact, any real attempt to raise rates did not appear before November, 1919, when the limits to credit were close before us. A more courageous and far-sighted policy would have been better.

It would be well to consider also whether it had not been better to rule against the tendency to expansion at its source by automatically adding a sliding scale of commissions to the rate of discount charged a member bank as its rediscounts rose relatively to its capital. This was proposed but passed by when the act was adopted.[1]

Moreover, the concentration of reserves, especially of gold, had been heralded as a mighty power for good. The convergence of gold into the hands of the Reserve Banks was accomplished; but it created a dangerous overconfidence. Even an abnormally high fund of gold is limited in its power. Already the deposits and notes, as the result of expansion, are so large that the reserve requirements leave no great margin of "free gold." A change in international trade which would call for gold exports would be serious. A further growth of business would be met by the fact that, outside of the sums in the Reserve Banks, there is no considerable amount of gold in the country to be drawn upon. Our exports may not for long continue to give us control of foreign gold, even if it were available.

A much more important matter, and one that is structural, arises from the provisions of the act regarding notes. Unhappily, the act shows the influence of an attitude of mind leaning toward Continental rather than toward British or American banking traditions. To be sure,

[1] See *supra*, p. 172. A bill is before Congress (April, 1920) to accomplish this very purpose.

there has always been with us, since greenback days, an inclination in some quarters to believe in the potency of note-issues in times of emergency. This has already been noted in connection with our panic of 1907.[1] But the whole spirit of our banking progress in recent years had been toward the organization of credit and the placing of our media of exchange on an elastic, automatic basis independent of fiscal operations. To give the Federal Reserve notes safety and elasticity by admitting commercial paper as a protection (with an additional gold reserve of 40 per cent) did not imply any necessity for confusing the quantity of note-issues with fiscal operations, or with general banking operations carried on by the check-and-deposit system, so well established here and in Great Britain. Since 1844 an expansion of British credit at the banking department of the Bank of England has gone on independently of the security of the bank-notes put out by the issue department. During the war Bank of England notes were not expanded by the fiscal operations of the Treasury. The one great blunder was the issue of currency notes (government paper) as a means of borrowing, the only measure which has seriously threatened the British gold standard. On the other hand, on the Continent, and especially in France and Germany—where notes, not checks drawn on deposits, form the main medium of exchange—government borrowings led directly to an enlargement of bank-notes. The outcome of this system in Germany has been a submergence of the note-issues under fiscal borrowings from the Reichsbank and the depreciation of the notes almost to the level of our old colonial currency. Under the Federal Reserve Act we have, unfortunately, inclined to Continental precedents, and not fully separated our Reserve

[1] See *supra*, Chapters III, IV, and VII.

notes—now our chief currency—from the fiscal operations of the Treasury and the purely credit functions of discount and deposit.

As already mentioned—oblivious to our own characteristic American development away from the methods in existence before 1838 by which notes were mixed up with credit operations—we seem to have drifted back to what is practically one reserve of gold for both demand-liabilities, notes and deposits.[1] When we entered the war, Reserve Bank statements gave a separate percentage of the reserve for notes and for deposits, but by the beginning of 1918, when the percentage of reserves had fallen from above 80 to 65, the percentage is given for the two combined liabilities. Therein lies a tendency to an undesirable end. When the 40 per cent reserve in gold for notes is subtracted from cash no considerable excess remains above the 35 per cent for deposits. That is, an increase of loans and so of deposits would alter the percentage of gold reserves and leave less for notes. And, as we have said, there is now, since the concentration of gold in the Reserve Banks, no large stock of outside gold on which to draw. The chart[2] published by the board for 1918 shows a very remarkable decline in the percentage of cash reserves to deposit and note liabilities, due almost entirely to a rapid increase of Reserve notes. From the point of view, therefore, of banking principles and experience, there ought to be no such close dependence of both notes and deposits on one gold reserve. The experience of Germany ought to be conclusive; while the steady movement of our own system by the end of 1919 in the same direction ought to force us to study the matter fully presented in the proposed bill of Chapter

[1] *Cf. supra*, pp. 16, 106, 135, 189, 256, 288, 305.
[2] *Bulletin*, January, 1919, p. 67.

IX (Section 8). The amount and convertibility of our Reserve notes ought in no way to be determined by fiscal operations.

Also, it should be remembered that there are yet non-member banks who can use Reserve notes in their reserves. Hence, their expansion of credit can go on as long as loans based on government securities can be rediscounted and notes be obtained thereby. The great task now immediately before us is to reconstruct the provisions of the Federal Reserve Act in such a way as to place the quantity and the redeemability of the Federal Reserve notes above all influences arising from the fiscal operations of the Treasury, or from the heaping up of unliquid assets of any kind.

APPENDIX I

PLAN OF THE AMERICAN BANKERS' ASSOCIATION

At a meeting of the Currency Commission of the American Bankers' Association, held in Chicago, January 18, 1908, there were laid before it the Aldrich Bill and the Fowler Bill. These bills were read section by section and discussed, and their provisions carefully considered. After thorough discussion the Commission reported as follows:

ALDRICH BILL

This bill proposes the issuing of additional bank notes based upon the security of other than United States bonds; namely, obligations of State, city or county, and first mortgage railway bonds. It is believed that this scheme is impracticable, unwise and financially unsound.

I. It is a departure from a safe system of note issues, which has been enjoyed since the foundation of the National banking system; it is a step backwards to the conditions which gave rise to the issuing of "wild-cat" currency before the Civil War, which currency was based upon bonds of a similar description. It may be the entering wedge to the acceptance of undesirable bonds as security for note issues. There are recent examples in the laws of New York State legalizing such bonds for Savings Banks.

II. The bill would not aid the business public in obtaining loans from banks in time of stress. In its practical operation it would cripple the lending power of the banks. Inasmuch as it is not good banking policy to hold any considerable amounts of such securities in the assets of commercial banks, the banks wishing to take out a new circulation would be obliged to purchase the new securities or to borrow them. The direct means of obtaining securities not generally held in the assets of the banks, would be found only by taking from their cash reserves one hundred thousand dollars in lawful money, in order to issue notes of seventy-five thousand dollars. By this process the bank would decrease its lawful reserves, which form the basis of loans. If the bonds behind these notes were borrowed instead of purchased, it would have the effect of increasing the liabilities of the

banks, which is wrong in principle and pernicious in practice. One hundred thousand dollars in lawful reserves would support loans of four hundred thousand dollars; while under the Aldrich Bill, one hundred thousand dollars taken from the reserves and invested in bonds, would only permit the lending of seventy-five thousand dollars. Thus, in its practical operation, it would seriously impair the ability of banks to meet the demands of the borrowing public.

III. This bill would tend to induce counties and municipalities to enlarge their obligations, because a fictitious bond market would be created. It would set a premium upon the increase of local indebtedness, which would be highly detrimental. It should be no part of Government legislation to aid in marketing securities.

IV. The necessity of ascertaining definite information as to population of cities, debt limits, valuation of taxable property, defaults, dividends on railway capital, and all other technical requirements, would entail such delays as to make the notes available only after the emergency had passed. A crisis is short, sharp and decisive; and the Aldrich Bill is a remedy offered to a man after recovery or death.

V. The provision of the Aldrich Bill to tax such additional notes six per cent will make their cost prohibitive. Calculated on a basis of one hundred thousand dollars of bonds purchased at par, bearing four per cent per annum, and estimating the lending rate of money to be six per cent, the net loss to banks taking out such circulation, would be two thousand dollars per annum, or at the rate of two per cent.

Illustration:

COST OF TAKING OUT NOTES AGAINST PURCHASED BONDS

$100,000 loanable at six per cent	$6,000	
Tax at six per cent on $75,000	4,500	
Total cost		$10,500
Four per cent int. on $100,000 of bonds	$4,000	
Loan $75,000 at six per cent	4,500	
Total income		8,500
Net loss		$2,000

This calculation does not include loss of interest on redemption fund nor the cost of printing and redemption of notes. When the price of such bonds becomes inflated by reason of their use as a basis of circulation, as in the case of United States bonds, the cost of the notes would be proportionately increased. If the bonds were borrowed instead of purchased, the cost of notes issued would be the same.

Illustration:

COST OF TAKING OUT NOTES AGAINST BORROWED BONDS

Tax on $75,000 notes at six per cent	$4,500	
Int. paid for use of $100,000 bonds at two per cent	2,000	
Total cost		$6,500
INCOME		
Six per cent interest on $75,000		4,500
Net loss		$2,000

Calculation is exclusive of loss of interest on redemption fund, and the cost of printing and redemption of notes.

It is thus proven that should banks be forced to take out these notes, the minimum rate to the borrower would be the actual cost of eight per cent, independent of any charge for the use of the capital, the expenses of doing business, and the risk of lending. If fair allowance be made for all legitimate charges, the net cost to borrowers would be as high as the prohibitive ten per cent tax now imposed by the Government on State bank issues.

VI. The high cost of taking out these notes must obviously be paid by the needy borrower; and in that event the bill must be regarded as a measure operating to tax the customer in a time when he especially requires assistance. Under normal conditions, a seasonal demand, arising in the autumn, causes higher rates of interest; while under the operation of the Aldrich Bill, the charge for currency needed in those periods, would be still further increased to the borrower. The enforced rise of interest rates would not only apply to loans effected by the use of such notes, but would at the same time increase the rates on the entire line of discounts carried by a bank, thus imposing a heavy and unnecessary burden upon the agricultural and business interests of the whole community. For these reasons, the Commission finds itself obliged to express its disapproval of the Aldrich Bill.

THE FOWLER BILL

After deliberate consideration of all the provisions of House Bill 12677, Sixtieth Congress, known as the New Fowler Bill, we disapprove it. While it contains certain meritorious features, it introduces schemes so far-reaching in their scope and touching so many collateral interests not germane to the real solution of our currency difficulties, that we believe its passage would unsettle rather than improve financial conditions.

Let us not be unmindful of the fact that in response to the demands of the people unsound and radical legislation has had its prece-

dents in our monetary history. After the panic of 1873 the demand for some action with reference to currency was so strong that Congress passed a bill increasing greenbacks by forty-four million dollars, a project which was wisely vetoed by President Grant. After the panic of 1893, Congress gave its approval to a measure providing for the coinage of fifty-five million dollars of silver, which was vetoed by President Cleveland, who followed the excellent precedent established by President Grant.

In these two instances we have had examples of hasty measures following financial panics, and in the two bills herein discussed we have what appears to us to be similar unwise measures following the recent crisis.

THE BANKERS' PLAN

The principles enunciated by the Commission, and approved by the American Bankers' Association in convention assembled at Atlantic City on September 23, 1907, have been at this time carefully reviewed, and we are still firm in the belief that they are economically sound. We have accordingly prepared a plan embodying these principles.

The difference between the original plan of the Commission (embodied in House Bill 23017, Fifty-ninth Congress) and the present plan is to be found in the provision that the holder of a credit note, instead of being a general creditor, shall have a prior lien on the assets of the issuing bank. The notes thus issued would be automatically adjusted in volume to the demands for currency. The security to the notes thus provided by pledging the whole of the assets of a bank would afford more desirable protection to a note holder than a portion of those assets in a segregated form; and such notes can be issued under provisions which will insure absolute safety to the note holder; an ample supply of currency to the public; relief from the disturbed commercial conditions, such as those through which we have recently passed; and finally the certain retirement of the notes when they have fulfilled their purpose in the hands of the public. The plan proposed by the Commission is as follows:

Section 1. Be it enacted by the Senate and House of Representatives of the United States of America, in Congress Assembled, that from and after the passage of this Act, any national banking association which has been in business for one year, and has a surplus fund equal to twenty per centum of its capital may take out for issue and circulation national bank notes without a deposit of United States bonds as now provided by law. Said notes shall be known as "National Bank Guaranteed Credit Notes." Said notes shall be issued in such form and denominations, and under such rules and regula-

tions as the Comptroller of the Currency shall fix. The amount of said notes so taken out by any national banking association may be equal to forty per centum of the amount of its national bank notes at any time outstanding, which are secured by the deposit of government bonds, but shall not exceed in amount twenty-five per centum of its capital; provided, however, that if at any time in the future the present proportion of the total outstanding unmatured United States bonds to the total capitalization of all national banking associations in active operation shall diminish, then the authorized issue of national bank guaranteed credit notes shall be increased to a correspondingly greater percentage of the bond-secured notes.

Section 2. That every national banking association taking out national bank guaranteed credit notes in accordance with the foregoing section, shall pay to the Treasurer of the United States in the months of January and July a tax of one and one-quarter per centum upon the average amount of such notes in circulation during the preceding half year.

Section 3. That any national banking association which has taken out national bank guaranteed credit notes in accordance with the provisions of Section 1 of this Act, may take out a further amount of national bank guaranteed credit notes equal to twelve and one-half per centum of its capital, but it shall pay to the Treasurer of the United States in the months of January and July a tax of two and one-half per centum upon the average amount of such notes in circulation during the preceding half year.

Section 4. That the total amount of bank notes issued by any national banking association, including national bank guaranteed credit notes taken out in accordance with the provisions of this Act, shall not exceed the amount of its paid-up capital.

Section 5. That any national banking association situated and doing business in a Central Reserve City, or a Reserve City, shall at all times have on hand in lawful money of the United States, an amount equal to at least twenty-five per centum of its national bank guaranteed credit notes in circulation; and every other national banking association shall at all times have on hand in lawful money of the United States an amount equal to at least fifteen per centum of its guaranteed credit notes in circulation; provided, however, that any national banking association situated and doing business in a Reserve City may keep one-half of its lawful money reserve on deposit in a national bank in a Central Reserve City, or in a Reserve City, and that every national banking association situated and doing business outside of a Central Reserve City, or a Reserve City, may keep three-fifths of its lawful money reserve on deposit in a national bank in a Central Reserve City, or in a Reserve City.

SECTION 6. That the taxes upon national bank guaranteed credit notes provided for in Sections 2 and 3 of this Act, shall be paid in lawful money to the Treasurer of the United States. Said taxes, when received, shall constitute a guaranty fund to redeem the notes of failed banks, and to pay the cost of printing and current redemption.

SECTION 7. That when any national banking association takes out any national bank guaranteed credit notes for issue and circulation, it shall deposit with the Treasurer of the United States in lawful money an amount equal to five per centum thereof. The amount so deposited shall be placed in the guaranty fund for the purposes thereof. But said amount shall be refunded to the respective banks as soon as the taxes provided for in Sections 2 and 3 of this Act maintain said guaranty fund above five per centum of the maximum amount of national bank guaranteed credit notes taken out for issue and circulation, but that no bank shall withdraw any part of its deposit of said five per centum until it shall have to its credit in said fund more than five per centum.

SECTION 8. That the Comptroller of the Currency shall designate certain cities conveniently located in the various sections of the United States for the current daily redemption of said national bank guaranteed credit notes; he shall fix rules and regulations for such redemption; and, before authorizing and permitting any national banking association to take out for issue and circulation any national bank guaranteed credit notes, he shall require such bank to make arrangements satisfactory to him for the current daily redemption of such notes in every redemption city so designated.

SECTION 9. That said national bank guaranteed credit notes, issued in accordance with the provisions of this Act shall be received at par in all parts of the United States in payment of taxes, excises, public lands, and all other dues to the United States, except duties on imports; and also for all salaries and other debts and demands owing by the United States to individuals, corporations, and associations within the United States except interest on public debt and in redemption of the national currency. Said notes shall be received upon deposit and for all purposes of debt and liability by every national banking association at par and without charge of whatsoever kind.

SECTION 10. That the holder of any national bank guaranteed credit note shall have a prior lien on the assets of the national banking association issuing it and on the statutory liability of shareholders.

SECTION 11. That upon the failure of a national banking association, all outstanding national bank guaranteed credit notes taken out by it in accordance with the provisions of this Act, shall upon presentation to the United States Treasurer be paid in lawful money out of the guaranty fund; but the United States Treasurer shall recover in

lawful money from the assets of the failed bank the amount of the guaranteed credit notes of such bank outstanding at the time of failure, and the same shall be paid into the guaranty fund as provided in Section 10 of this Act.

SECTION 12. That any national banking association desiring to retire its national bank guaranteed credit notes or to go into liquidation shall pay into the guaranty fund an amount of lawful money equal to the amount of its national bank guaranteed credit notes then outstanding.

SECTION 13. That any national banking association desiring to take out national bank guaranteed credit notes and having notes outstanding in excess of sixty-two and one-half per centum of its paid-up capital, to secure the payment of which United States bonds have been deposited, may, upon the deposit of lawful money, redeem such excess without reference to the limitation of nine million dollars each month prescribed in the Act approved March fourth, nineteen hundred and seven.

APPENDIX II

PLAN OF THE NATIONAL MONETARY COMMISSION[1]

A BILL

To Incorporate the National Reserve Association of the United States, and for Other Purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the National Reserve Association of the United States be, and it is hereby, created and established for a term of fifty years from the date of filing with the Comptroller of the Currency a certificate of paid-in capital stock as hereinafter provided. It shall have an authorized capital equal in amount to twenty per centum of the paid-in and unimpaired capital of all banks eligible for membership in said National Reserve Association. Before said association shall be authorized to commence business two hundred million dollars of the capital stock shall be subscribed and one hundred million dollars of its capital shall be paid in cash. The capital stock of said association shall be divided into shares of one hundred dollars each. The outstanding capital stock may be increased from time to time as subscribing banks increase their capital or as additional banks become subscribers or may be decreased as subscribing banks reduce their capital or leave the association by liquidation. The head office of the National Reserve Association shall be located in Washington, in the District of Columbia.

Sec. 2. Upon duly making and filing with the Comptroller of the Currency the certificate hereinafter required the National Reserve Association of the United States shall become a body corporate and as such and by that name shall have power—

First. To adopt and use a corporate seal.

Second. To have succession for a period of fifty years from the date of said certificate.

Third. To make all contracts necessary and proper to carry out the purposes of this act.

[1] The first tentative plan was proposed by the chairman, Senator Aldrich, January 16, 1911; a revised outline, October 14, 1911; and the final plan with a report was laid before Congress January 8, 1912.

Fourth. To sue and be sued, complain and defend, in any court of law or equity, as fully as natural persons.

Fifth. To elect or appoint directors and officers in the manner hereinafter provided and define their duties.

Sixth. To adopt by its board of directors by-laws not inconsistent with this act, regulating the manner in which its property shall be transferred, its general business conducted, and the privileges granted to it by law exercised and enjoyed.

Seventh. To purchase, acquire, hold, and convey real estate as hereinafter provided.

Eighth. To exercise by its board of directors or duly authorized committees, officers, or agent, subject to law, all the powers and privileges conferred upon the National Reserve Association by the act.

Sec. 3. All national banks, and all banks or trust companies chartered by the laws of any State of the United States or of the District of Columbia, complying with the requirements for membership in the said National Reserve Association, hereinafter set forth, may subscribe to its capital to an amount equal to twenty per centum of the paid-in and unimpaired capital of the subscribing bank, and not more nor less; and each of such subscribing banks shall become a member of a local association as hereinafter provided. Fifty per centum of the subscriptions to the capital stock of the National Reserve Association shall be fully paid in; the remainder of the subscriptions or any part thereof shall become a liability of the subscribers, subject to call and payment thereof whenever necessary to meet the obligations of the National Reserve Association under such terms and in accordance with such regulations as the board of directors of the National Reserve Association may prescribe.

The subscriptions of a bank or trust company incorporated under the laws of any State or of the District of Columbia to the capital stock of the National Reserve Association shall be made subject to the following conditions:

First. That (*a*) if a bank, it shall have a paid-in and unimpaired capital of not less than that required for a national bank in the same locality; and that (*b*) if a trust company, it shall have an unimpaired surplus of not less than twenty per centum of its capital, and if located in a place having a population of six thousand inhabitants or less shall have a paid-in and unimpaired capital of not less than fifty thousand dollars; if located in a city having a population of more than six thousand inhabitants and not more than fifty thousand inhabitants, shall have a paid-in and unimpaired capital of not less than one hundred thousand dollars; if located in a city having a population of more than fifty thousand inhabitants and not more than two hundred thousand inhabitants shall have a paid-in and unimpaired capital of not

less than two hundred thousand dollars; if located in a city having a population of more than two hundred thousand inhabitants and not more than three hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than three hundred thousand dollars; if located in a city having a population of more than three hundred thousand inhabitants and not more than four hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than four hundred thousand dollars, and if located in a city having a population of more than four hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than five hundred thousand dollars.

Second. That it shall have and agree to maintain against its demand deposits a reserve of like character and proportion to that required by law of a national bank in the same locality: *Provided, however*, That deposits which it may have with any subscribing national bank, State bank, or trust company in a city designated in the national banking laws as a reserve city or a central reserve city shall count as reserve in like manner and to the same extent as similar deposits of a national bank with national banks in such cities.

Third. That it shall have and agree to maintain against other classes of deposits the percentages of reserve required by this act.

Fourth. That it shall agree to submit to such examinations and to make such reports as are required by law and to comply with the requirements and conditions imposed by this act and regulations made in conformity therewith.

The words "subscribing banks" when used hereafter in this act shall be understood to refer to such national banks, and banks or trust companies chartered by the laws of any State of the United States or of the District of Columbia, as shall comply with the requirements for membership herein defined.

Sec. 4. The Secretary of the Treasury, the Secretary of Agriculture, the Secretary of Commerce and Labor, and the Comptroller of the Currency are hereby designated a committee to effect the organization of the National Reserve Association, and the necessary expenses of said committee shall be payable out of the Treasury upon vouchers approved by the members of said committee, and the Treasury shall be reimbursed by the National Reserve Association to the full amount paid out therefor.

Within sixty days after the passage of this act said committee shall provide for the opening of books for subscriptions to the capital stock of said National Reserve Association in such places as the said committee may designate. Before the subscription of any bank to the capital stock of the National Reserve Association shall be accepted, said bank shall file with the organization committee or after organiza-

tion with the National Reserve Association a certified copy of a resolution adopted by the board of directors of said bank accepting all the provisions and liabilities imposed by this act and authorizing the president or cashier of said bank to subscribe for said stock.

Sec. 5. When the subscriptions to the capital stock of the National Reserve Association shall amount to the sum of two hundred million dollars the organization committee hereinbefore provided shall forthwith proceed to select fifteen cities in the United States for the location of the branches of said National Reserve Association: *Provided*, That one branch shall be located in the New England States, including the States of Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut; two branches in the Eastern States, including the States of New York, New Jersey, Pennsylvania, and Delaware; four branches in the Southern States, including the States of Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, Louisiana, Texas, Arkansas, Kentucky, Tennessee, and also the District of Columbia; four branches in the Middle Western States, including the States of Ohio, Indiana, Illinois, Michigan, Wisconsin, Minnesota, Iowa, and Missouri; four branches in the Western and Pacific States, including the States of North Dakota, South Dakota, Nebraska, Kansas, Montana, Wyoming, Colorado, New Mexico, Oklahoma, Washington, Oregon, California, Idaho, Utah, Nevada, and Arizona.

When the cities in which the branches are to be located have been selected the organization committee shall forthwith divide the entire country into fifteen districts, with one branch of the National Reserve Association in each district: *Provided*, That the districts shall be apportioned with due regard to the convenient and customary course of business and not necessarily along State lines.

The districts may be readjusted, and new districts and new branches may from time to time be created by the directors of the National Reserve Association whenever, in their opinion, the business of the country requires.

Sec. 6. All subscribing banks within a district shall be grouped by the organization committee or after organization, by the National Reserve Association, into local associations of not less than ten banks, with an aggregate capital and surplus of at least five million dollars, for the purposes hereinafter prescribed: *Provided*, That the territory included in each association shall be contiguous and that in apportioning the territory due regard shall be had for the customary course of business and for the convenience of the banks forming the association: *Provided further*, That in apportioning the territory to local associations comprising a district every bank and all of the territory within said district shall be located within the boundaries of some local asso-

ciation: *And provided further*, That every subscribing bank shall become a member only of the local association of the territory in which it is situated.

The banks uniting to form a local association shall, by their presidents or vice presidents, under authority from the board of directors, execute a certificate in triplicate setting forth the name of the association, the names of the banks composing it, its principal place of business, its territorial limits, and the purposes for which it is organized. One copy of this certificate shall be filed with the Comptroller of the Currency, one copy shall be filed with the National Reserve Association, and one copy shall be filed with the branch of the National Reserve Association of the district in which the local association is included. Upon the filing of such certificates the local association therein named shall become a body corporate and by the name so designated may sue and be sued and exercise the powers of a body corporate for the purposes mentioned in this act, and not otherwise.

The local associations in each district may be readjusted from time to time and new associations may be authorized by the directors of the National Reserve Association.

Sec. 7. Each local association shall have a board of directors, the number to be determined by the by-laws of the local association. Three-fifths of that number shall be elected by ballot cast by the representatives of the banks that are members of the local association, each bank having one representative and each representative one vote for each of the positions to be filled without reference to the number of shares which the bank holds in the National Reserve Association. Two-fifths of the whole number of directors of the local association shall be elected by the same representatives of the several banks that are members of the association, but in voting for these additional directors each representative shall be entitled to as many votes as the bank which he represents holds shares in the National Reserve Association: *Provided*, That in case forty per centum of the capital stock in any subscribing bank is owned directly or indirectly by any other subscribing bank, or in case forty per centum of the capital stock in each of two or more subscribing banks, being members of the same local association, is owned directly or indirectly by the same person, persons, copartnership, voluntary association, trustee, or corporation, then and in either of such cases, neither of such banks shall be entitled to vote separately, as a unit, or upon its stock, except that such banks acting together, as one unit, shall be entitled to one vote, for the election of the board of directors of such local association. In no case shall voting by proxy be allowed. The authorized representative of a bank, as herein provided, shall be its president, vice president, or cashier.

Each director shall take an oath that he will, so far as the duty devolves upon him, diligently and honestly administer the affairs of such association and will not knowingly violate or willingly permit to be violated any of the provisions of this act.

The directors originally elected shall hold office until the second Tuesday in February immediately following their election, and thereafter the directors shall be elected annually on that date and shall hold office for the term of one year.

The board of directors of the local association shall have authority to make by-laws, not inconsistent with law, which shall be subject to the approval of the National Reserve Association.

Sec. 8. Each of the branches of the National Reserve Association shall have a board of directors, the number, not less than twelve in addition to the ex officio member, to be fixed by the by-laws of the branch. These directors shall be elected in the following manner:

The board of directors of each local association shall elect by ballot a voting representative. One-half of the elected directors of the branch shall be elected by the vote of such representatives, each representative having one vote for each of the positions to be filled, without reference to the number of shares which the banks composing the association which he represents holds in the National Reserve Association. One-third of the elected directors shall be elected by the same voting representatives, but each voting representative in this case shall have a number of votes equal to the number of shares in the National Reserve Association held by all the banks composing the local association which he represents. The remaining one-sixth of the directors shall be chosen by the directors already elected and shall fairly represent the agricultural, commercial, industrial, and other interests of the district and shall not be officers nor, while serving, directors of banks, trust companies, insurance companies, or other financial institutions. The manager of the branch shall be ex officio a member of the board of directors of the branch and shall be chairman of the board.

Each director shall take an oath that he will, so far as the duty devolves upon him, diligently and honestly administer the affairs of such association and will not knowingly violate or willingly permit to be violated any of the provisions of this act.

All the members of the board of directors of the branch except the ex officio member shall at the first meeting of the board be divided into three classes. One-third of the directors shall hold office until the first Tuesday in March immediately following the election; one-third of the directors shall hold office for an additional period of one year after the first Tuesday in March immediately following the election; the remaining one-third of the directors shall hold office for an

additional period of two years after the first Tuesday in March immediately following the election. All elections shall be held on the first Tuesday in March of each year, and after the first election all directors shall be elected for a term of three years: *Provided,* That the by-laws of the National Reserve Association shall provide for the manner of filling any vacancies which may occur in the board of directors of the branches.

The board of directors of the branch shall have authority to make by-laws, not inconsistent with law, which shall be subject to the approval of the National Reserve Association.

Sec. 9. The National Reserve Association shall have a board of directors, to be chosen in the following manner:

First. Fifteen directors shall be elected, one by the board of directors of each branch of the National Reserve Association. In case the number of districts shall be increased hereafter, each additional district shall be entitled to elect an additional director of this class.

Second. Fifteen additional directors shall be elected, one by the board of directors of each branch of the National Reserve Association, who shall fairly represent the agricultural, commercial, industrial, and other interests of the district, and who shall not be officers nor, while serving, directors of banks, trust companies, insurance companies, or other financial institutions. In case the number of districts shall be increased hereafter, each additional district shall be entitled to elect an additional director of this class.

Third. Nine additional directors shall be elected by voting representatives chosen by the boards of directors of the various branches, each of whom shall cast a number of votes equal to the number of shares in the National Reserve Association held by the banks in the branch which he represents. Not more than one of the directors of this class shall be chosen from one district. Directors of each of the three classes named above shall be residents of the district from which they are elected.

Fourth. There shall be seven ex officio members of the board of directors, namely: The governor of the National Reserve Association, who shall be chairman of the board, two deputy governors of the National Reserve Association, the Secretary of the Treasury, the Secretary of Agriculture, the Secretary of Commerce and Labor, and the Comptroller of the Currency.

No member of any national or State legislative body shall be a director of the National Reserve Association, nor of any of its branches, nor of any local association.

All the members of the board, except the ex officio members, shall at the first meeting of the board be divided into three classes. One-third of the directors shall hold office until the first Tuesday in April

immediately following the election; one-third of the directors shall hold office for an additional period of one year after the first Tuesday in April immediately following the election; the remaining one-third of the directors shall hold office for an additional period of two years after the first Tuesday in April immediately following the election. All elections shall be held on the first Tuesday in April of each year, and after the first election all directors shall be elected for a term of three years: *Provided*, That all directors provided for in sections seven, eight, and nine of this Act shall serve until their successors have qualified: *And provided further*, That the by-laws of the National Reserve Association shall provide for the manner of filling any vacancies which may occur in the board of directors of the National Reserve Association.

Each director shall take an oath that he will, so far as the duty devolves upon him, diligently and honestly administer the affairs of such association and will not knowingly violate or willingly permit to be violated any of the provisions of this act.

The board of directors of the National Reserve Association shall have authority to make by-laws, not inconsistent with law, which shall prescribe the manner in which the business of said association shall be conducted and the privileges granted to it by law exercised and enjoyed.

SEC. 10. The executive officers of the National Reserve Association shall consist of a governor, two deputy governors, a secretary, and such subordinate officers as may be provided by the by-laws. The governor of the National Reserve Association shall be selected by the President of the United States from a list of not less than three submitted to him by the board of directors of said association. The person so selected shall thereupon be appointed by the said board as governor of the National Reserve Association for a term of ten years, subject to removal for cause by a two-thirds vote of the board. There shall be two deputy governors, to be elected by the board, for a term of seven years, subject to removal for cause by a majority vote of the board. The two deputy governors first elected shall serve for terms of four years and seven years, respectively. In case of any vacancy in the office of deputy governor his successor shall be elected to fill the unexpired term. In the absence of the governor or his inability to act the deputy who is senior in point of service shall act as governor. The board of directors shall have authority to appoint such other officers as may be provided for by the by-laws.

SEC. 11. When the National Reserve Association is duly organized its board of directors shall call upon the subscribing banks for a payment of fifty per centum on the amount of their subscriptions to the capital stock of said association. When one hundred million dollars

of capital have been paid in the board of directors shall at once proceed to execute and file with the Secretary of State a certificate showing the payment of one hundred million dollars on capital stock, and they shall further file with the Comptroller of the Currency a certificate showing the title and location of each bank which has subscribed to the capital stock of the National Reserve Association, the number of shares subscribed by each, and the amount paid thereon.

SEC. 12. Shares of the capital stock of the National Reserve Association shall not be transferable, and under no circumstances shall they be hypothecated nor shall they be owned otherwise than by subscribing banks, nor shall they be owned by any such bank other than in the proportion herein provided. In case a subscribing bank increases its capital it shall thereupon subscribe for an additional amount of the capital of the National Reserve Association equal to twenty per centum of the bank's increase of capital, paying therefor its then book value as shown by the last published statement of said association. A bank applying for membership in the National Reserve Association at any time after its formation must subscribe for an amount of the capital of said association equal to twenty per centum of the capital of said subscribing bank, paying therefor its then book value as shown by the last published statement of said association. When the capital of the National Reserve Association has been increased either on account of the increase of capital of the banks in said association or on account of the increase in the membership of said association, the board of directors shall make and execute a certificate showing said increase in capital, the amount paid in and by whom paid. This certificate shall be filed in the office of the Comptroller of the Currency. In case a subscribing bank reduces its capital it shall surrender a proportionate amount of its holdings in the capital of said association, and if a bank goes into voluntary liquidation it shall surrender all of its holdings of the capital of said association. In either case the shares surrendered shall be canceled and the bank shall receive in payment therefor a sum equal to their then book value as shown by the last published statement of said association.

If any member of the National Reserve Association shall become insolvent and a receiver be appointed, the stock held by it in said association shall be canceled and the balance, after paying all debts due by such insolvent bank to said association (such debts being hereby declared to be a first lien upon the paid-in capital stock), shall be paid to the receiver of the insolvent bank.

Whenever the capital stock of the National Reserve Association is reduced, either on account of the reduction in capital of members of said association or the liquidation or insolvency of any member, the board of directors shall make and execute a certificate showing such

reduction of capital stock and the amount repaid to each bank. This certificate shall be filed in the office of the Comptroller of the Currency.

Sec. 13. The National Reserve Association and its branches and the local associations shall be exempt from local and State taxation except in respect to taxes upon real estate.

Sec. 14. The directors of the National Reserve Association shall annually elect from their number an executive committee and such other committees as the by-laws of the National Reserve Association may provide. The executive committee shall consist of nine members, of which the governor of the National Reserve Association shall be ex officio chairman and the two deputy governors and the Comptroller of the Currency ex officio members, but not more than one of the elected members shall be chosen from any one district.

The executive committee shall have all the authority which is vested in the board of directors, except the power of nomination, appointment, and removal of the governor and deputy governors and except such as may be specifically delegated by the board to other committees or to the executive officers, or such as may be specifically reserved or retained by the board.

Sec. 15. There shall be a board of examination elected annually by the board of directors from among their number, excluding the members of the executive committee, of which the Secretary of the Treasury shall be ex officio chairman. It shall be the duty of this board to carefully examine the condition and the business of the National Reserve Association and of its branches and to make a public statement of the result of such examination at least once a year.

Sec. 16. Each branch shall have a manager and a deputy manager appointed from the district by the governor of the National Reserve Association with the approval of the executive committee of said association and the board of directors of the branch, and subject to removal at any time by the governor with the approval of the executive committee of the National Reserve Association. The powers and duties of the manager and deputy manager and of the various committees of the branches shall be prescribed by the by-laws of the National Reserve Association.

Sec. 17. The directors of each local association shall annually elect from their number a president, a vice president, and an executive committee, whose powers and duties shall be determined by the by-laws of the local association, subject, however, to the approval of the National Reserve Association.

Sec. 18. The National Reserve Association shall cause to be kept at all times, at the head office of the association, a full and correct list of the names of the banks owning stock in the association and the num-

ber of shares held by each. Such list shall be subject to the inspection of all the shareholders of the association, and a copy thereof on the first Monday of July of each year shall be transmitted to the Comptroller of the Currency.

SEC. 19. The earnings of the National Reserve Association shall be disposed of in the following manner:

After the payment of all expenses and the franchise and other taxes not provided for in this section the shareholders shall be entitled to receive an annual dividend of four per centum on the paid-in capital, which dividend shall be cumulative. Further annual net earnings shall be disposed of as follows: First, a contingent fund shall be created, which shall be maintained at an amount equal to one per centum on the paid-in capital, and shall not exceed in any event two million dollars and shall be used to meet any possible losses. Such fund shall, upon the final dissolution of the National Reserve Association, be paid to the United States and shall not under any circumstances be included in the book value of the stock or be paid to the shareholders. Second, one-half of additional net earnings shall be paid into the surplus fund of the National Reserve Association until said fund shall amount to twenty per centum of the paid-in capital, one-fourth shall be paid to the United States as a franchise tax, and one-fourth shall be paid to the shareholders, until the shareholders' dividend shall amount to five per centum per annum on the paid-in capital: *Provided*, That no such dividends, exclusive of the cumulative dividends above provided for, shall at any time be paid in excess of five per centum in any one year. Whenever and so long as the contingent fund has been provided for and the five per centum dividend has been paid to shareholders one-half of the additional earnings shall be added to the surplus fund, and one-half shall be paid to the United States as a franchise tax. Whenever and so long as the surplus fund of the National Reserve Association amounts to twenty per centum of the paid-in capital and the shareholders shall have received dividends not exceeding five per centum, all excess earnings shall be paid to the United States as a franchise tax.

SEC. 20. Any member of a local association may apply to such association for a guaranty of the commercial paper which it desires to rediscount at the branch of the National Reserve Association in its district. Any such bank receiving a guaranty from a local association shall pay a commission to the local association, to be fixed in each case by its board of directors. Expenses and losses in excess of commissions shall be met by an assessment of the members of the local association in proportion to the ratio which their capital and surplus bears to the aggregate capital and surplus of the members of the local association, which assessment shall be made by its board of directors, and

the commission received for such guaranty, after the payment of expenses and possible losses, shall be distributed among the several banks of the local association in the same proportion. A local association shall have authority to require security from any bank offering paper for guaranty, or it may decline to grant the application. The total amount of guaranties by a local association to the National Reserve Association shall not at any time exceed the aggregate capital and surplus of the banks forming the guaranteeing association.

Sec. 21. Any local association may by a vote of three-fourths of its members and with the approval of the National Reserve Association, assume and exercise such of the powers and functions of a clearing house as are not inconsistent with the purposes of this act. The National Reserve Association may require any local association to perform such services in facilitating the domestic exchanges of the National Reserve Association as the public interests may require.

Sec. 22. All of the privileges and advantages of the National Reserve Association shall be equitably extended to every bank of any of the classes herein defined which shall subscribe to its proportion of the capital stock of the National Reserve Association and shall otherwise conform to the requirements of this act: *Provided*, That the National Reserve Association may suspend a bank from the privileges of membership for refusal to comply with such requirements or for a failure for thirty days to maintain its reserves, or to make the reports required by this act, or for misrepresentation in any report or examination as to its condition or as to the character or extent of its assets or liabilities.

Sec. 23. The National Reserve Association shall be the principal fiscal agent of the United States. The Government of the United States shall upon the organization of the National Reserve Association deposit its general funds with said association and its branches, and thereafter all receipts of the Government, exclusive of trust funds, shall be deposited with said Association and its branches, and all disbursements by the Government shall be made through said association and its branches.

Sec. 24. The Government of the United States and banks owning stock in the National Reserve Association shall be the only depositors in said association. All domestic transactions of the National Reserve Association shall be confined to the Government and the subscribing banks, with the exception of the purchase or sale of Government or State securities or securities of foreign governments or of gold coin or bullion.

Sec. 25. The National Reserve Association shall pay no interest on deposits.

Sec. 26. The National Reserve Association may through a branch

rediscount for and with the indorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transactions; that is, notes and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, and not including notes or bills issued or drawn for the purpose of carrying stocks, bonds, or other investment securities.

Such notes and bills must have a maturity of not more than twenty-eight days, and must have been made at least thirty days prior to the date of rediscount. The amount so rediscounted shall at no time exceed the capital of the bank for which the rediscounts are made. The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm, or corporation, rediscounted for any one bank, shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank.

Sec. 27. The National Reserve Association may through a branch also rediscount, for and with the indorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transactions as hereinbefore defined, having more than twenty-eight days, but not exceeding four months, to run, but in such cases the paper must be guaranteed by the local association of which the bank asking for the rediscount is a member.

Sec. 28. Whenever, in the opinion of the governor of the National Reserve Association, the public interests so require, such opinion to be concurred in by the executive committee of the National Reserve Association and to have the definite approval of the Secretary of the Treasury, the National Reserve Association may through a branch discount the direct obligation of a depositing bank, indorsed by its local association, provided that the indorsement of the local association shall be fully secured by the pledge and deposit with it of satisfactory securities, which shall be held by the local association for account of the National Reserve Association; but in no such case shall the amount loaned by the National Reserve Association exceed three-fourths of the actual value of the securities so pledged.

Sec. 29. The power of rediscount and discount granted to the National Reserve Association by sections twenty-six, twenty-seven, and twenty-eight of this act shall in each case be exercised through the branch in the district in which the bank making the application is located.

Sec. 30. The National Reserve Association shall have authority to fix its rates of discount from time to time, which when so fixed shall be published, and shall be uniform throughout the United States.

Sec. 31. National banks are hereby authorized to accept drafts or bills of exchange drawn upon them, having not more than four months to run, properly secured, and arising out of commercial trans-

actions as hereinbefore defined. The amount of such acceptances outstanding shall not exceed one-half the capital and surplus of the accepting bank, and shall be subject to the restrictions of section fifty-two hundred of the Revised Statutes.

SEC. 32. The National Reserve Association may, whenever its own condition and the general financial conditions warrant such investment, purchase from a subscribing bank acceptances of banks or acceptors of unquestioned financial responsibility arising out of commercial transactions as hereinbefore defined. Such acceptances must have not exceeding ninety days to run, and must be of a character generally known in the market as prime bills. Such acceptances shall bear the indorsement of the subscribing bank selling the same, which indorsement must be other than that of the acceptor.

SEC. 33. The National Reserve Association may invest in United States bonds; also in obligations, having not more than one year to run, of the United States or its dependencies, or of any State, or of foreign governments.

SEC. 34. The National Reserve Association shall have power, both at home and abroad, to deal in gold coin or bullion, to make loans thereon, and to contract for loans of gold coin or bullion, giving therefor, when necessary, acceptable security, including the hypothecation of any of its holdings of United States bonds.

SEC. 35. The National Reserve Association shall have power to purchase from its subscribing banks and to sell, with or without its indorsement, checks or bills of exchange, arising out of commercial transactions as hereinbefore defined, payable in such foreign countries as the board of directors of the National Reserve Association may determine. These bills of exchange must have not exceeding ninety days to run, and must bear the signatures of two or more responsible parties, of which the last one shall be that of a subscribing bank.

SEC. 36. The National Reserve Association shall have power to open and maintain banking accounts in foreign countries and to establish agencies in foreign countries for the purpose of purchasing, selling, and collecting foreign bills of exchange, and it shall have authority to buy and sell, with or without its indorsement, through such correspondents or agencies, checks or prime foreign bills of exchange arising out of commercial transactions, which have not exceeding ninety days to run, and which bear the signatures of two or more responsible parties.

SEC. 37. It shall be the duty of the National Reserve Association or any of its branches, upon request, to transfer any part of the deposit balance of any bank having an account with it to the credit of any other bank having an account with the National Reserve Asso-

ciation. If a deposit balance is transferred from the books of one branch to the books of another branch, it may be done, under regulations to be prescribed by the National Reserve Association, by mail, telegraph, or otherwise, at rates to be fixed at the time by the manager of the branch at which the transaction originates.

Sec. 38. The National Reserve Association may purchase, acquire, hold, and convey real estate for the following purposes and for no other:

First. Such as shall be necessary for the immediate accommodation in the transaction of the business either of the head office or of the branches.

Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.

Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.

Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by said association, or shall purchase to secure debts due to it.

But the National Reserve Association shall not hold the possession of any real estate under mortgage or the title and possession of any real estate purchased to secure any debts due to it for a longer period than five years.

Sec. 39. All subscribing banks must conform to the following requirements as to reserves to be held against deposits of various classes, but the deposit balance of any subscribing bank in the National Reserve Association and any notes of the National Reserve Association which it holds may be counted as the whole or any part of its required reserve:

First. On demand deposits: National banks in different localities shall maintain the same percentages of reserve against demand deposits as is now required by law, and the same percentages of reserve against demand deposits shall be required of all other subscribing banks in the same localities.

Second. On time deposits: All time deposits and moneys held in trust payable or maturing within thirty days shall be subject to the same reserve requirements as demand deposits in the same locality. All time deposits and moneys held in trust payable or maturing more than thirty days from date shall be subject to the same reserve requirements as demand deposits for the thirty days preceding their maturity, but no reserves shall be required therefor except for this period. Such time deposits and moneys held in trust, payable only at a stated time not less than thirty days from date of deposit, must be represented by certificates or instruments in writing and must not be allowed to be withdrawn before the time specified without thirty days' notice.

Sec. 40. National banks may loan not more than thirty per centum of their time deposits, as herein defined, upon improved and unencumbered real estate, such loans not to exceed fifty per centum of the actual value of the property, which property shall be situated in the vicinity or in the territory directly tributary to the bank: *Provided,* That this privilege shall not be extended to banks acting as reserve agents for banks or trust companies.

Sec. 41. All demand liabilities, including deposits and circulating notes, of the National Reserve Association shall be covered to the extent of fifty per centum by a reserve of gold (including foreign gold coin and gold bullion) or other money of the United States which the national banks are now authorized to hold as a part of their legal reserve: *Provided,* That whenever and so long as such reserve shall fall and remain below fifty per centum the National Reserve Association shall pay a special tax upon the deficiency of reserve at a rate increasing in proportion to such deficiency as follows: For each two and one-half per centum or fraction thereof that the reserve falls below fifty per centum a tax shall be levied at the rate of one and one-half per centum per annum: *Provided further,* That no additional circulating notes shall be issued whenever and so long as the amount of such reserve falls below thirty-three and one-third per centum of its outstanding notes.

Sec. 42. In computing the demand liabilities of the National Reserve Association a sum equal to one-half of the amount of the United States bonds held by the association which have been purchased from national banks, and which had previously been deposited by such banks to secure their circulating notes, shall be deducted from the amount of such liabilities.

Sec. 43. The National Reserve Association shall make a report, showing the principal items of its balance sheet, to the Comptroller of the Currency once a week. These reports shall be made public. In addition, full reports shall be made to the Comptroller of the Currency by said association coincident with the five reports called for each year from the national banks.

Sec. 44. All subscribing banks shall, under regulations to be prescribed by the National Reserve Association make a report monthly, or oftener if required, to said association showing the principal items of their balance sheets.

Sec. 45. All reports of national-bank examiners in regard to the condition of banks shall hereafter be made in duplicate, and one copy shall be filed with the National Reserve Association for the confidential use of its executive officers and branch managers.

Sec. 46. The National Reserve Association may accept copies of the reports of the national-bank examiners for subscribing national

banks and also copies of the reports of State-bank examiners for subscribing State banks and trust companies, in States where the furnishing of such information is not contrary to law: *Provided, however,* That the standard of such examinations, both National and State, meets the requirements prescribed by the National Reserve Association. The National Reserve Association shall have the right at any time to examine or cause to be examined by its own representatives any subscribing bank. The National Reserve Association may make such payments to national and State examiners for such services required of them as the directors may consider just and equitable.

SEC. 47. All provisions of law requiring national banks to hold or to transfer and deliver to the Treasurer of the United States bonds of the United States other than those required to secure outstanding circulating notes and Government deposits are hereby repealed.

SEC. 48. There shall be no further issue of circulating notes by any national bank beyond the amount now outstanding. National banks may maintain their present note issue, but whenever a bank retires the whole or any part of its existing issue its right to reissue the notes so retired shall thereupon cease.

SEC. 49. The National Reserve Association shall, for a period of one year from the date of its organization, offer to purchase at a price not less than par and accrued interest the two per centum bonds held by subscribing national banks and deposited to secure their circulating notes. The National Reserve Association shall take over the bonds so purchased and assume responsibility for the redemption upon presentation of outstanding notes secured thereby. The National Reserve Association shall issue, on the terms herein provided, its own notes as the outstanding notes secured by such bonds so held shall be presented for redemption and may issue further notes from time to time to meet business requirements, it being the policy of the United States to retire as rapidly as possible, consistent with the public interests, bond-secured circulation and to substitute therefor notes of the National Reserve Association of a character and secured and redeemed in the manner provided for in this act.

SEC. 50. All note issues of the National Reserve Association shall at all times be covered by legal reserves to the extent required by section forty-one of this act and by notes or bills of exchange arising out of commercial transactions as hereinbefore defined or obligations of the United States.

SEC. 51. Any notes of the National Reserve Association in circulation at any time in excess of nine hundred million dollars which are not covered by an equal amount of lawful money, gold bullion, or foreign gold coin held by said association, shall pay a special tax at the rate of one and one-half per centum per annum, and any notes

in excess of one billion two hundred million dollars not so covered shall pay a special tax at the rate of five per centum per annum: *Provided*, That in computing said amounts of nine hundred million dollars and one billion two hundred million dollars the aggregate amount of any national-bank notes then outstanding shall be included.

SEC. 52. The circulating notes of the National Reserve Association shall constitute a first lien upon all its assets and shall be redeemable in lawful money on presentation at the head office of said association or any of its branches. It shall be the duty of the National Reserve Association to maintain at all times a parity of value of its circulating notes with the standard established by the first section of the act of March fourteenth, nineteen hundred, entitled "An act to define and fix the standard of value, to maintain the parity of all forms of money issued or coined by the United States, to refund the public debt, and for other purposes."

SEC. 53. The circulating notes of the National Reserve Association shall be received at par in payment of all taxes, excises, and other dues to the United States, and for all salaries and other debts and demands owing by the United States to individuals, firms, corporations, or associations, except obligations of the Government which are by their terms specifically payable in gold, and for all debts due from or by one bank or trust company to another, and for all obligations due to any bank or trust company.

SEC. 54. The National Reserve Association and its branches shall at once, upon application and without charge for transportation, forward its circulating notes to any depositing bank against its credit balance.

SEC. 55. Upon application of the National Reserve Association the Secretary of the Treasury shall exchange the two per centum bonds of the United States bearing the circulation privilege purchased from subscribing banks for three per centum bonds of the United States without the circulation privilege, payable after fifty years from the date of issue. The National Reserve Association shall hold the three per centum bonds so issued during the period of its corporate existence: *Provided*, That after five years from the date of its organization the Secretary of the Treasury may at his option permit the National Reserve Association to sell not more than fifty million dollars of such bonds annually: *And provided further*, That the United States reserves the right at any time to pay any of such bonds before maturity, or to purchase any of them at par for the trustees of the postal savings, or otherwise.

SEC. 56. The National Reserve Association shall pay to the Government a special franchise tax of one and one-half per centum annually during the period of its charter upon an amount equal to the par

value of such United States bonds transferred to it by the subscribing banks.

SEC. 57. That banking corporations for carrying on the business of banking in foreign countries and in aid of the commerce of the United States with foreign countries and to act when required as fiscal agents of the United States in such countries may be formed by any number of persons, not less in any case than five, who shall enter into articles of association which shall specify in general terms the object for which the banking corporation is formed and may contain any other provisions not inconsistent with the provisions of this section which the banking corporation may see fit to adopt for the regulation and conduct of its business and affairs, which said regulations shall be signed, in duplicate, by the persons uniting to form the banking corporation and one copy thereof shall be forwarded to the Comptroller of the Currency and the other to the Secretary of State, to be filed and preserved in their offices.

That the persons uniting to form such banking corporation shall under their hands make an organization certificate which shall specify, first, the name assumed by such banking corporation, which name shall be subject to approval by the comptroller; second, the foreign country or countries or the dependencies or colonies of foreign countries or the dependencies of the United States where its banking operations are to be carried on; third, the place in the United States where its home office shall be located; fourth, the amount of its capital stock and the number of shares into which the same shall be divided; fifth, the names and places of residence of the shareholders and the number of shares held by each of them; and, sixth, a declaration that said certificate is made to enable such persons to avail themselves of the advantages of this section.

That no banking corporation shall be organized under the provisions of this section with a less capital than two million dollars, which shall be fully paid in before the banking corporation shall be authorized to commence business, and the fact of said payment shall be certified by the Comptroller of the Currency and a copy of his certificate to this effect shall be filed with the Secretary of State: *Provided*, That the capital stock of any such bank may be increased at any time by a vote of two-thirds of its shareholders with the approval of the Comptroller of the Currency and that the capital stock of any such bank which exceeds two million dollars may be reduced at any time to the sum of two million dollars by the vote of shareholders owning two-thirds of the capital.

That every banking corporation formed pursuant to the provisions of this section shall for a period of twenty years from the date of the execution of its organization certificate be a body corporate, but shall

not be authorized to receive deposits in the United States nor transact any domestic business not necessarily related to the business being done in foreign countries or in the dependencies of the United States. Such banking corporations shall have authority to make acceptances, buy and sell bills of exchange, or other commercial paper relating to foreign business, and to purchase and sell securities, including securities of the United States or of any State in the Union. Each banking corporation organized under the provisions of this section shall have power to establish and maintain for the transaction of its business a branch or branches in foreign countries, their dependencies, or the dependencies of the United States at such places and under such regulations as its board of directors may deem expedient.

A majority of the shares of the capital stock of such banking corporation shall be held and owned by citizens of the United States or corporations chartered under the laws of the United States or of any State of the Union, and a majority of the members of the board of directors of such banking corporations shall be citizens of the United States. Each director shall own in his own right at least one hundred shares of the capital stock of the banking corporation of which he is a director.

Whenever the Comptroller shall become satisfied of the insolvency of any such banking corporation he may appoint a receiver who shall proceed to close up such corporation in the same manner in which he would close a national bank, the disposition of the assets of the branches to be subject to any special provisions of the laws of the country under whose jurisdiction such assets are located.

The annual meeting of every such banking corporation shall be held at its home office in the United States, and every such banking corporation shall keep at its home office books containing the names of all stockholders of such banking corporation and members of its board of directors, together with copies of the reports furnished by it to the Comptroller of the Currency exhibiting in detail and under appropriate heads the resources and liabilities of the banking corporation. Every such banking corporation shall make reports to the Comptroller of the Currency at such times as he may require, and shall be subject to examinations when deemed necessary by the Comptroller of the Currency through examiners appointed by him; the compensation of such examiners to be fixed by the Comptroller of the Currency.

Any such banking corporation may go into liquidation and be closed by the vote of its shareholders owning two-thirds of its stock.

Any bank doing business in the United States and being the owner of stock in the National Reserve Association may subscribe to the stock of any banking corporation organized under the provisions of

this section, but the aggregate of such stock held by any one bank shall not exceed ten per centum of the capital stock of the subscribing bank.

SEC. 58. Congress reserves the right to alter or amend the provisions of this act to take effect at the end of any decennial period from and after the organization of the National Reserve Association.

SEC. 59. All acts or parts of acts inconsistent with the provisions of this act are hereby repealed.

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